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Paulson Institute

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Remarks by Henry M. Paulson, Jr., on the United States and China at a Crossroads

You don't hear much about "joint" interests between the United States and China anymore.

That worries me.

And frankly, it should worry all of us.

There's obviously a lot of finger pointing between Beijing and Washington these days.

But what I must say—as a practitioner, who has been involved with China and US-China relations for some three decades—is that this reflects rapid change and the emergence of a very different strategic dynamic.

I am an American patriot.

And so I find myself spending more time in China than my family would like precisely because it is in America's interest to find a way to deal with this new, and sometimes difficult, China.

I have strived, and sometimes struggled, to do that:

As an investment banker.

As a CEO.

As America's Treasury Secretary.

And today, as the leader of an institute dedicated to sustainable economic cooperation between the United States and China.

And yet for all the struggles, for all the tension, for all the disagreement, America has been well served, in my view, by the effort to work through problems.

My friend, Vice President Wang Qishan, has been here with us in Singapore over the last two days. And in this 10th anniversary year of the 2008 financial crisis, I look back at our work together—when global markets were on the brink of collapse—as an example of tough-minded but cooperative interaction.

Without this, I can assure you that the markets and our economies would look significantly different today.

Indeed, my colleagues in China know that I speak my mind, often bluntly—much as I did during the financial crisis.

So today, I am going to offer some thoughts in a constructive spirit, because it is necessary to judge the past and present—sometimes harshly—if we are to try for a better future.

What I'd like to do with these remarks is to talk about three things: First, how the United States and China arrived at this moment of heightened tension;

Second, the most acute risks I see for each side;

And third, a few modest suggestions of the kinds of steps necessary to begin the long process of setting US-China relations onto a more sustainable footing.

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So, how did we get here?

The drivers of the current downward spiral aren't, in my view, necessarily complicated.

And while my version of the story isn't, of course, the whole story, it reflects, I believe, what has happened on the American side.

First, we have diverging interests:

On many issues where the United States and China should agree, such as North Korea, we too often pursue divergent approaches.

That means that common interests haven't yielded enduring cooperation.

Worse, our lack of sufficient cooperation has persuaded many people that we never shared an interest in the first place.

Second, the United States and China disagree about some important rules governing the international system.

One example is maritime rights and customs—a disagreement that recently brought our navies into a near-collision on the high seas.

Third, American and Chinese views are, quite simply, opposed in some critical areas.

On some issues, we advocate vastly different ideas for international governance.

For example, China and Russia argue for cyber sovereignty and the right of the state to control data and cross-border data flows. The US and the EU, while not in perfect agreement with one another, both reject those Chinese and Russian views.

Taken together, these and other drivers, such as China's cyber practices and island building in the South China Sea, have fueled a new consensus in Washington that China is not just a strategic competitor but very possibly our major long-term adversary.

America's longstanding "engagement" policy is now widely viewed as being of little use for its own sake.

Nobody is arguing against dialogue.

But nearly everybody is arguing that the results of US-China dialogue and engagement have been poor.

The tariff war between the US and China will eventually be concluded—hopefully soon.

Nobody wins a trade war.

And China can agree to enough of what President Trump seeks to enable a deal that he can be proud of – if it also marks the beginning of the negotiation of a high-ambition trade or investment agreement.

But I also happen to believe that the underlying tensions will persist.

That is because the problems we face, and our divergence of views, even in the economic area, is much broader.

Unless these broader and deeper issues are addressed, we are in for a long winter in US-China relations.

Let's just take the economics.

The United States played the decisive role in facilitating China's entry into the World Trade Organization. Yet 17 years after China entered the WTO, China still has not opened its economy to foreign competition in so many areas.

It retains joint venture requirements and ownership limits.

And it uses technical standards, subsidies, licensing procedures, and regulation as non-tariff barriers to trade and investment.

Nearly 20 years after entering the WTO, this is simply unacceptable.

It is why the Trump Administration has argued that the WTO system needs to be modernized and changed. And I agree.

But it also helps explain why so many influential voices now argue for a "decoupling" of the two economies, especially with respect to technology-related trade and investment that will disrupt supply chains.

These arguments will not go away anytime soon.

They will drive a variety of new approaches from this administration and its successors.

Both Democrats and Republicans are saying so.

And this negative view of China unites politicians from both left and right who agree on nothing else.

Trade with China has hurt some American workers. And they have expressed their grievances at the ballot box.

So while many attribute this shift to the Trump Administration, I do not.

What we are now seeing will likely endure for some time within the American policy establishment.

China is viewed—by a growing consensus—not just as a strategic challenge to the United States but as a country whose rise has come at America's expense.

In this environment, it would be helpful if the US-China relationship had more advocates.

That it does not reflects another failure:

In large part because China has been slow to open its economy since it joined the WTO, the American business community has turned from advocate to skeptic and even opponent of past US policies toward China. American business doesn't want a tariff war but it does want a more aggressive approach from our government.

How can it be that those who know China best, work there, do business there, make money there, and have advocated for productive relations in the past, are among those now arguing for more confrontation?

The answer lies in the story of stalled competition policy, and the slow pace of opening, over nearly two decades.

This has discouraged and fragmented the American business community.

And it has reinforced the negative attitudinal shift among our political and expert classes.

In short, even though many American businesses continue to prosper in China, a growing number of firms have given up hope that the playing field will ever be level.

Some have accepted the Faustian bargain of maximizing today's earnings per share while operating under restrictions that jeopardize their future competitiveness.

But that doesn't mean they're happy about it.

Nor does it mean they aren't acutely aware of the risks — or thinking harder than ever before about how to diversify their risks away from, and beyond, China.

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Meanwhile, Chinese firms are permitted to operate in other countries in ways that foreign firms cannot act in China itself.

That exacerbates these underlying tensions.

And so I do believe that China's actions and failure to open up have contributed to this more confrontational view in the United States.

The messages from Beijing over the last five years sound this way to American ears:

First, the Communist Party commands all.

That is why, for example, Party Committees, not corporate boards, are being strengthened within both public and private firms as a tool of external supervision.

Second, private businesses must support the strategic goals of the state, not necessarily market or commercial goals.

That is why the emphasis in China's state-owned enterprise "reforms" has been on mixed ownership — pooling private with state capital to buttress and strengthen the state-owned firms.

Third, foreign firms are "not needed" in many areas and must act in ways that bolster China's indigenization of technology, knowledge, and business processes.

And this third apparent message is absolutely central to the current intensification of US-China tensions.

It is not just that foreign technologies are being transferred and digested.

It is that they are being reworked so that foreign technologies become Chinese technologies through an indigenization process that many of the multinational CEOs I talk to believe is grossly unfair to the innovators and dreamers at the heart of their companies.

And this may now become a source of heightened confrontation as China exports aspects of its model—and its standards—through initiatives like the Belt and Road.

For example, while most of the headlines about the Belt and Road focus on ports, power generation, and highways, the unsung story may be the "Digital Silk Road," an initiative that could export China’s model of cyber-governance — the very model that I earlier mentioned as a source of tension with the US and the EU.

Now, as I said, I know quite well that Chinese decision-makers have their own long list of grievances and concerns with US policy.

Washington has work to do to address some of these Chinese concerns.

For instance, I don’t like to see Chinese investments in our country turned down when there is no national security risk, especially when these will create American jobs.

But frankly, the political context has changed dramatically in both capitals.

So just as Chinese policymakers tell Americans to stop trying to make China into something that it isn’t, I encourage Chinese decision-makers to recognize the changed context in the United States.

The fact is, Beijing’s “asks” cannot be addressed in this new context unless something happens to shake the current trajectory or raise questions in Washington about the wisdom of the emerging consensus I have described.

Americans increasingly believe China is a peer competitor, pursuing adversarial policies, and a major strategic challenge.

And I am describing this to you in stark terms because I believe that, if we stay on this trajectory, it will comprise the context of US policy for years to come.

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So, that brings us to the risks.

And they are considerable.

It would be easy to step back from all this and conclude that, while we face an intensification of strategic competition, it does not disrupt our economies wholesale, much less our daily lives.

But sadly, I think the risks of a new age of disruption are considerable.

Here’s the nub of it:

For forty years, the US-China relationship has been characterized by the integration of four things—goods, capital, technology, and people.

And over these forty years, economic integration between the two countries was supposed to mitigate security competition.

But an intellectually honest appraisal must now admit both that this hasn’t happened and that the reverse is taking place:

And technology is a critical driver of this change.

In today’s world, technology is a critical part of business success, blurring the lines between economic competitiveness and national security.

Security competition is bleeding extensively into economics and business.

And more than that, economic tensions are reaching a breaking point.

The result is that, after forty years of integration, a surprising number of political and thought leaders on both sides advocate policies that could forcibly de-integrate the two countries across all four of these baskets.

The integration of trade in goods could come undone — as supply chains are forcibly broken, especially for those that use sensitive technology.

Integration through cross-border capital flows will come under ever greater pressure — as restrictions on Chinese investment take hold across big sectors in the United States.

Indeed, if this trend continues, we need to consider the possibility that the integration of global innovation ecosystems will collapse as a result of mutual efforts by the United States and China to exclude one another.

Some in the United States now advocate a Cold War-style technology denial regime. And this is partly because of a growing consensus that China has been using policies and strategies that foster the indigenous development of high technology to set its own standards and, ultimately, pursue self-reliance.

Pervasive technology theft, forced technology transfer, including within joint ventures, and different models of internet governance and cross-border data flows are also contributing factors.

Yet innovation and technology cannot be separated from business competitiveness.

So, such a balkanization of technology could further harm global innovation, not to mention the competitiveness of firms around the world.

Meanwhile, the integration of people, especially the brightest young students, could also stall — as Washington potentially bans Chinese students from studying whole categories of science and engineering subjects.

If all this persists—across all four baskets of goods, capital, technology, and people—I fear that big parts of the global economy will ultimately be closed off to the free flow of investment and trade.

And that is why I now see the prospect of an Economic Iron Curtain—one that throws up new walls on each side and unmakes the global economy, as we have known it.

Now, as a practical matter, rather than an aspirational one, China still relies a lot on global capital, trade, investment, and foreign know-how.

And so the most strident calls for “decoupling” are actually coming from the United States and, to a lesser extent, from Europe, not from China.

But here’s the problem for those in my country who advocate a US-China “divorce”:

“Decoupling” is easier when you’re actually a couple.

But the United States and China are not, in fact, a couple. There are more than two players here. And the rest of Asia, in particular, gets a vote.

So the US can try to divorce China by restricting flows of goods, capital, technology, and people. But what if others, especially in Asia don’t want to follow suit?

Many years of working in and around Asia have taught me this:

I do not believe that any country in Asia can afford to divorce China, or even wishes to.

That is a function of their geography, of economic gravity, and of the strategic reality they live with each and every day.

It is true that many governments and businesses around the world share Washington’s current concerns. And sometimes, these governments and businesses are pursuing similar policy and business choices, particularly with regard to investment screening for national security risk, which is being bolstered in a number of countries, especially in Western Europe.

But let us not presume this also means that everyone, including America’s closest allies, is ready to “divorce” China, as some in Washington would now have it.

On the contrary, no country, in my view, will “divorce” a major nation that remains, even amid a slowdown, among the world’s fastest growing major economies.

So in its effort to isolate China, the United States risks isolating itself.

Consider what would happen, for instance, if multinational companies decided that they should be headquartered somewhere else — still aiming to ride the wave of a growing Chinese economy but in a country less hostile to their doing business with Beijing.

Hosting scores of leading, best-in-class multinational corporations is among America’s greatest competitive strengths. And it is one that America now risks surrendering — if it cannot get right its links with the world’s fastest-growing economies, including China’s.

Frankly, de-integration is inevitable, and even necessary, in some areas—not least to protect our national security.

But it is decidedly not in America’s interest to attempt this across the board.

Divorce doesn’t work well for global businesses.

And the same could be said for the trade policies that drive companies and countries away.

This is exactly what worries me about the new clause Washington inserted into the recent US-Mexico-Canada trade agreement, which aims to short-circuit or even veto efforts by America’s partners to open China’s market through their own trade negotiations.

Why would Asian countries, which are negotiating the Regional Comprehensive Economic Partnership, among a group of 16 that includes China, walk away from their negotiation at the behest of the country that pulled out of the Trans-Pacific Partnership?

I presume they will not.

So instead of pursuing a carefully calibrated de-integration—focused on sensitive and critical areas—the US seems instead to be flirting with a comprehensive de-integration.

And through initiatives like that new trade clause, Washington now strikes many people as attempting to disrupt all aspects of China’s external economic relationships.

This risks setting Washington up for a new round of battles with its allies and partners—the very partners it needs to help alter Chinese behavior.

And this, Ladies and Gentlemen, is what I mean by American “self-isolation.”

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But let us also be clear that if China wants to keep its relationship with the United States from spinning out of control, it is going to have to look hard at some of its choices and policies.

Above all, that means China will need to rediscover the spirit of market driven reform and opening up, which would address longstanding criticisms while doing wonders for the Chinese economy too.

This year marks the fortieth anniversary of “reform and opening” in China — the remarkable transformation launched by Deng Xiaoping and other leaders at the Third Plenum in 1978.

It’s been a good run for China over these forty years.

And it’s been an especially good run for China since it entered the WTO in 2001.

Its $1 trillion economy in 2001 has become a $13 trillion behemoth, measured in nominal GDP.

Its $220 billion in foreign exchange reserves has ballooned over the same period to a staggering $3 trillion, some of which is now being plowed into direct investments and acquisitions overseas.

But what China has lost, especially over the last decade-and-a-half, is the bold impulse to reform and open up that led leaders like Zhu Rongji to undertake significant changes to the state-led sector in the 1990s, as Beijing prepared for its WTO accession.

Zhu Rongji saw competition as a key to China’s long-term economic success.

In those days, China’s future seemed inextricably linked to the world’s.

But today, the prevailing view in the US is that China is increasingly content to pursue its own standards, privilege its domestic rules, and erect rather than demolish walls for foreign competitors.

And so I continue to encourage China’s leaders to pursue reforms in three baskets, in particular:

The first is competition reforms.

Foreign firms need to be allowed to compete with Chinese firms on a level playing field.

And for that matter, Chinese private firms should be allowed to compete with state firms in the same way.

The second area involves the role of the market.

As an investment banker, I worked with hundreds of firms in dozens of countries on five continents. And I learned this: the firms that succeed are run as commercial firms, not as agents of the state.

They allow the market to drive key decisions.

And they respond to market, not government, signals.

China will always have a large state-owned sector, of course.

So China should strengthen those pillars that permit firms—yes, even the state-owned firms—to be run commercially.

That means strengthening corporate boards, not Communist Party Committees, as the tool of external supervision.

And it means allowing top-flight managers to run these firms as real managers.

And by the way, running all firms, state and private, as commercial firms will help level the playing field for foreign firms too.

Third, China must foster and protect innovation.

Policies of forced technology transfer should end. China should work to prevent cyber-theft, and better protect intellectual property. And a mandate for indigenous innovation should not be used to limit competition, including through the use of standards.

And so China has an important decision to make.

The key to avoiding an Economic Iron Curtain is for China to see its interest clear in making these kinds of reforms and changes.

If China doesn't move quickly, I suspect the calls for divorce will intensify.

And it pains me to say that.

But at this point, after forty years, when we have had one kind of relationship but now, quite clearly, face the daunting task of transitioning to a new one – anchored in a realistic and more sustainable – strategic framework – divorce is a real risk.

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Ladies and Gentlemen, I don't believe the current trajectory can be easily reversed.

It has been a long time coming.

Big structural changes to US-China relations were inevitable — and at this point are definitely desirable.

There aren't easy answers. But, then, nothing worthwhile is ever easy.

As a first priority, it is essential that we alter the downward spiral, for the well-being of our nations and the world.

But to do so will require thoughtful people to make some tough decisions.

To get things started, I offer these considerations for both sides:

For China:

First, do no harm.

For example, implement robust rules of engagement to prevent PLA Navy captains from the kind of maneuver that nearly resulted in a collision in the South China Sea last month.

Second, work constructively with America's allies and partners.

In recent years, when China's relations with Japan, or India, or South Korea, or the Philippines have taken a serious downturn, those pressures have bled into US-China relations too. It is no longer possible to separate US-China relations from China's posture in Asia.

Third, be bold. Open your economy. Have confidence that your firms can compete, and no longer need to hide behind a wall of government protection.

And as I have already said, I believe this kind of competition would be good for China too.

Fourth, be proactive in protecting proprietary foreign know-how and end policies that directly or indirectly compel technology transfer.

Fifth, work with the US on its topmost strategic priorities, especially North Korea.

It is sad to me that in an area like that, where the US and China so clearly should share an interest in denuclearization, we too often have appeared to be working at cross-purposes in recent years.

As for the United States:

First, dial down the rhetoric.

Strategic competition is a fact.

We have compelling differences of national interest between our two countries.

And we clearly have clashing security concepts, not least in the South China Sea.

But China does not pose an existential threat to American civilization. In the 242nd year of our great democratic experiment, we should have more confidence in America and the resilience of our system.

We should prepare for the obvious strategic challenges from China. But in doing so, let's not sacrifice those values—or the commitment to openness—that has made us the strongest, most competitive, and most admired country in the world.

Second, enlist partners. And then, working in coalition with these partners, try to foster some workable understandings with Beijing.

China has a different political and economic system. So this isn't easy – and it never has been.

But while China doesn't support a liberal order, it does need a functioning global order, just as we do.

Therefore, we should still be working hard to see if China is prepared to help ensure that the institutions we rely on can be made more effective to deal with today's pressing problems.

The World Trade Organization is perhaps the best example.

It is in desperate need of an upgrade.

So why shouldn't China and the United States be part of leading efforts to bring the WTO into the digital age?

Here in Singapore, you know that the business of Asia is business.

And so while it is true that American trade and investment policies surely needed a new direction, I simply do not understand the Trump Administration's rejection of approaches that would align the trade architecture in Asia more compellingly.

To be blunt about this, I wish President Trump would reconsider his decision to withdraw from the Trans-Pacific Partnership.

A TPP 2.0 would offer a ready-made vehicle to shape the trade environment in which Beijing operates.

Third, negotiate with China.

And when you negotiate, do so with clear objectives.

That means finding frameworks not just to discuss issues but resolve them.

And resolving them almost certainly means working in closer coordination with like-minded partners. For instance, why not pursue a multi-party investment agreement with China — jointly withholding access to the US, EU, and Japanese markets, not as an end in itself but instead as part of a structured negotiation with Beijing that aims to test the prospect for opening there with clear incentives and strong disincentives?

Fourth, and under any scenario, invest in America—big time.

A strong military.

A strong economy.

Strong educational institutions.

Strong investments in science and engineering.

Openness to the world.

Investment in alliances.

Investment in security and economic partnerships on every continent, but especially in Asia and Europe.

These things are essential if the United States is to compete and thrive in the world of the 21st century.

There is simply no substitute for getting our own policies right.

And that, Ladies and Gentlemen, is the most essential ingredient if America is to compete with China smartly, now and into the future — with favor not fear, with confidence not caution.

There is no doubt in my mind that how the United States deals with China, and how they deal with us, will shape the geopolitical landscape for this century.

The US-China strategic interaction is by far the most consequential in the world.

I am very sobered by the trajectory we are on now.

And ultimately, I think it could pose a risk to the very functioning of the international system.

As Treasury Secretary, I presided over the US response to the 2008 financial crisis, so I know a little something about systemic risk. And I simply cannot see how the international system can endure when the two countries that comprise some 40 percent of global GDP and over 50 percent of global growth are working at cross purposes, attempting to de-integrate their two economies, and contesting the foundations of a rules-based order at every turn.

No, Washington and Beijing don’t always share interests. But on a variety of functional issues that can make or break the global economy, they still need to work in complementary ways. Or failing that, they need to manage and attempt to mitigate the consequences of their disputes.

If the US and China cannot find a way to develop a workable consensus, it will pose a systemic risk of monumental proportions — not just to the global economy, as I dealt with, but to international order as we know it and to world peace.

Both countries need an international system that functions – because international order is one of those things that is simply too big to fail. And so the alternative is unacceptable.

And that is why I am hopeful that statesmanship will prevail.

Right now, we are proceeding down divergent paths and we are in danger of facing a long winter before we reach what may still be a rather patchy spring. But I believe a spring will come. So the questions are, how long will this winter last, and how much unnecessary dysfunction and pain will be inflicted along the way?

The answer will be determined by the capacity and willingness of leaders in Washington and Beijing to think creatively – and sometimes even disruptively.

In 1972, our leaders established an initial framework for a world beset by Cold War and locked into an ideological conflict.

At various points along the way, they have had to recalibrate.

Today's world looks nothing like the world of the 1970s, or of the 2000s, or even of the years when my friend, Wang Qishan, and I tackled the financial crisis.

New technologies, new economic challenges, new geopolitical challenges – all of these have eroded the frameworks of the past.

And so we've reached another of those consequential moments.

And the stakes—for our economies, and for the world—are higher than ever before.

We need to craft a new framework that works for today's world, not the world of the past.

And for that, we will need statesmanship—wise and strong leadership in Washington and Beijing.

Thank you.

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