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Globalization Commentaries

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US-China Investment Treaty: A Threat to Stability and Growth in China

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Under the radar screen at the US-China Strategic and Economic Dialogue (SE&D) last month, the US and China continued to discuss a bi-lateral investment treaty (BIT). If the final negotiated text looks like the majority of US BITs it could threaten financial stability and economic growth in China.

The US and China began negotiations toward a BIT in 2008 under the Bush Administration. After taking office, US President Barack Obama gave his seal of approval to the negotiations at the November 2009 SE&D when the two nations agreed to "expedite" them.

China's development over the past thirty years has been unprecedented. Not only has per capita growth been faster than 8 percent per annum throughout the period, but according to the World Bank China has brought 300 million people—a number roughly the size of the entire population in the US—out of poverty.

China may just be the best "globalizer" among developing nations. China hasn't followed "Washington Consensus" policies of rapidly liberalizing trade and investment and pulling the state out of economic affairs, policies that have been followed in much of Latin America where growth rates have been lower.

To be sure, China has embraced markets and realized that integration with the world economy is essential for development. China's approach can be characterized best by a phrase used by Deng Xiaping, "crossing the river by touching each stone." In other words, the Chinese have taken a gradual and experimental approach to globalization in which there is recognition of the key role for the state in fostering markets during the development process.

Taking this approach to the macroeconomic realm, China has adopted a managed approach to monetary and exchange policies where the yuan is pegged to the dollar and coupled with capital controls to grant the country independent monetary policies.

In numerous recent studies, economists at the Institute of World Economics and Politics at the Chinese Academy of Social Sciences have shown that China's capital controls have not only been effective in maintaining financial stability before and during the global financial crisis, but they will also be essential to help China loosen its hold on the exchange rate over time.

From a microeconomic perspective, China has supported research and development and post-secondary education, and coupled that support with aggressive industrial policy to develop strategic industries such as electronics, automobiles, and now wind power.

As Zhongxiu Zhao and his colleagues from the University of International

Business and Economics in Beijing show in a recent issue of the peer-reviewed journal China and the World Economy, part of the industrial strategy has been to learn from foreign firms by screening which types of firms they want to enter certain markets and regions, requiring joint ventures with foreign firms so that Chinese firms can acquire the technological capabilities to be a world class exporter, and so forth.

Foreign firms have never been overly enthusiastic about such policies, but they certainly saw the benefits of access to China's booming economy as outweighing the costs of working together.

These policies would have to change if the BIT with the US conforms to the many BITs the US currently has in place. US BITS have shunned the use of capital controls and performance requirements on foreign investment. Moreover, contemporary BITs have "investor-state" dispute resolution systems whereby a foreign investor can directly remove a dispute out of Chinese governance structures to a private tribunal at the World Bank and seek financial compensation directly from Chinese government coffers.

Corporate-led disputes stand in stark contrast to disputes at the World Trade Organization (which largely permits the China's industrial policies toward FDI) where governments engage in the dispute process and therefore provide a diplomatic screen over more egregious cases by taking into account public welfare and broader geo-political concerns.

China has approximately 120 BITs and the US has close to 40. Thus far, none of China's BITs strip China's ability to deploy capital controls for speculative capital or to use performance requirements on foreign direct investment. Indeed, China's recent BIT with Germany defers to China's capital control regime as the standard and leaves out measures on performance requirements altogether.

According to a recent study I did for the United Nations, the Chinese model is more consistent with the BITS of other major capital exporting nations. China should bargain hard to ensure that a BIT with the US looks more like Chinese BITs when it comes to capital controls and performance requirements– so as to maintain the ability to preserve macroeconomic stability and generate economic growth for years to come.