

China-US Relations, Industrial Policy and Overcapacity¹

C. Fred Bergsten

Yu Yongding CF40 Advisor

Abstract: *Regarding China-US relations, Dr. Bergsten argues that a managed competitive cooperation and a functional decoupling strategy are the only ways to constructively manage bilateral relations, emphasizing the need to set out different groups of issues. The two countries can continue to seek new topics within the global economic agenda where rules have yet to be established and collaboratively develop new regulations. Among the new U.S. presidential candidates, Harris is seen as a more willing partner for constructive cooperation compared to the unpredictability of Trump. Yu Yongding said that cooperation between the U.S. and China is crucial, and acknowledging this could resolve many specific issues. Unfortunately, both the Trump and Biden administrations have adopted policies aimed at containing China, which is fundamentally misguided and detrimental to both sides. There is hope that the future U.S. government will change this policy to strengthen China-US cooperation. The U.S. has not sufficiently supported WTO rules in recent years and should cease obstructing the WTO's functionality in the future.*

On the issue of industrial policy and overcapacity, Bergsten contended that past industrial policies in the U.S. have been unsuccessful, and a new wave of industrial policy is unlikely to yield better results. Production aimed at meeting domestic and foreign demand does not necessarily equate to overcapacity. However, substantial government subsidies, preferential treatment for domestic firms, and discrimination against foreign investments can indeed lead to problems. A dialogue on industrial policies between the U.S. and China is anticipated. Yu Yongding Yu believed that two cases of overcapacity should be distinguished. At the macroeconomic level, China's problem is insufficient effective demand, thus overcapacity does not exist. In contrast, for specific industries like electric vehicles and lithium batteries, market mechanisms should be primarily used to address overcapacity, as the government lacks the capacity to determine its existence. Discussions on these issues should clearly separate industrial policy from trade policy.

Yang Yanqing (moderator): Dr. Bergsten, I would like to begin to ask you a very long question. Since our constructive discussion based on your highly acclaimed book, the US V.S. China, the Quest for Global Economic

Leadership, I think at least two things happened. First, the mainstream opinion leaders in the US tended to believe that the China "economic miracle" had been over. Second, the milestone innovation of ChatGPT pushed technology competition between China and the US escalating into a new stage. My question is do you still hold the view that the conditional competitive cooperation and functional decoupling between China and US will still be a realistic fix? And if yes, who will buy this strategy more, Donald Trump or Kamala Harris?

¹ C. Fred Bergsten is the Director Emeritus and Nonresident Senior Fellow of Peterson Institute for International Economics. Yu Yongding is the Chairman of Pushan Foundation and Academician of Chinese Academy of Social Sciences.

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C.Fred Bergsten: The answer to your question is a simple yes. I think the only way to deal constructively with both the tension between the US and China bilaterally and the need for effective global economic leadership is to pursue a strategy of what I call functional decoupling. What that means is simply to set out different groups of issues, some of which will remain contentious and competitive and even confrontational between our two countries, but others of which we decide and agree to pursue in a more cooperative way.

And to illustrate that, I would pick up on the discussion between Rubin and Huang Yiping. They talked about two specific issues, a possible “Marshall Plan for Clean Energy Development” and the issue of artificial intelligence (AI), both of which I think would be very promising candidates for an ongoing cooperative approach between the US and China, even as we continue to disagree over a number of security and other issues.

There’s a particular reason why I say that. In the competition for global economic leadership, China frequently says that it’s being asked to conform to international rules that it had no role in writing, including in the World Trade Organization, in the International Monetary Fund or elsewhere. And I understand that complaint and that concern.

So it seemed to me, we should always be looking for new issues that come on to the global economic agenda where there are no rules yet, and where it would be completely feasible for the US and China to work together from ground zero, from scratch, to put in place new rules, obviously, with the cooperation of other countries. But the US and China, as the two most important countries, should work very closely together to develop new rules of the road and new norms to govern those critical issues. Rubin and Yiping would just agree. And I certainly agree those are very crucial issues for the future of both the world economy and our own countries. But there are no rules, no guidelines, no norms that govern behavior in those areas. And they are both very controversial areas.

In the case of AI, there is enormous potential, but there’s also great risk possibility. In trying to find a more stable path, both for bilateral relations between China and the United States, and for the world economy, which is suffering from trade wars, technology wars and alike, it would be a critical step forward if China and the United States could agree to work together to develop new rules of the road.

Those issues obviously have security implications where both countries will continue to do things for security reasons. But they also have huge economic and social implications that are not related to security. The two countries can, and in my view, should pursue in a cooperative mode. And that, in turn, could lead the way to a new set of relationships between our countries where the world economy as a whole, and that’s what I would call functional decoupling--moving ahead on issues like cooperatively, while leaving disagreements on security and other issues. This is a two-way relationship, which I think is the only way toward a stable equilibrium.

Yang Yanqing: Thank you, Fred, very lucid elaboration, but there is still a very daunting task we need to tackle. On the one hand, I think security is a very,very difficult issue. On the other hand, we can work on some new rules. But still a security issue is there. We will leave that a little bit and later on, and maybe we can dig deeper. Back to my earlier question to your great “functional decoupling” idea, do you think Donald Trump or Kamala Harris would like it?

C.Fred Bergsten: I think Kamala Harris would probably be more inclined toward the cooperative approach.

The Biden administration, of which she has been an integral part, has been seeking something along the lines that I’m discussing. The Biden people, including Anthony Blinken, Jake Sullivan, President Biden himself, have talked about grouping the US-China issues into different baskets. One broadly competitive, and that’ll be a lot of it; another would be cooperative, such as climate change and pandemics. They have shown a keen interest, I think, in moving down two tracks,

namely what I call functional decoupling.

However, they have not pursued that very vigorously or very rigorously. I'm suggesting it be done in a much more systematic and consistent way. The United States would have to stop regarding every issue as a security issue that needs to be pursued by export controls or tariffs or some of the restrictions. There's an interesting article on the latest issue of *Foreign Affairs* by Daniel Drezner, which says the United States these days regards everything as a security issue, which means nothing is a security issue. The US has to compromise or modify its mindset in that direction, too.

My long answer to your question is Biden administration has shown some interest and some readiness to pursue the functional decoupling strategy. I think they have sought discussions with China on some of these issues recently, including artificial intelligence. And another reason I suggest pursuing a very ambitious strategy of artificial intelligence is that China and the United States, as I understand it, agreed in their most recent meetings that they would set up a dialogue, a consultative process on that issue. So it's already begun to get on the agenda between our two countries. I'm suggesting it be much more ambitious, much more strategic.

I am pretty sure the Biden administration and Kamala Harris would be disposed to move in that direction. While Donald Trump is totally unpredictable. He had no interest in constructive cooperation with China in his first term and was very aggressive in attacking China in a number of way. So my strong suspicion is that Kamala Harris would be a much more reliable, much more interested, much more constructive partner in that sense.

Yang Yanqing: Yeah, thank you for the very clear answers. And moving on to Professor Yu Yongding. What is your view on today's US-China very, very important and very difficult bilateral relations? And what is your view on the risk of functional decoupling? What China should do?

Yu Yongding: Fred has emphasize the importance of the a general direction of a Sino-American relationship. I think before solving specific issues, we should emphasize importance about general directions. Fred just mentioned functional decoupling, but actually, I know Fred emphasized the importance of Sino-American cooperation for a long time, at least 30 years, as far as I know. I know him almost 30 years. He coined the term of "G2". Many people forgot about it. But I appreciate his view of managing Sino-American relationship to help establish a stable global order. And later on, I think he once mentioned that it is China together with the United States, even more than United States that brought global economy out of a great recession and ended global depression. He praised China and said that this is a very positive, constructive economic leadership for China. I think he mentioned a lot of things. And even recently, he also mentioned that it's very important, is fundamentally important to lay a foundation by improving Chinese-American relationship for a stable, successful economic order.

I'm not quite sure whether my quotation is right. I think, perhaps, it is right. This is his basic idea. I appreciate Fred's consistency in emphasizing the importance of Sino-American cooperation. I think that's extremely important. I don't know whether in the future there will be a "G1", "G2", "G3", "G4", "G0". But anyway, cooperation between China and United States is very important. If we accept that, then I think many specific issues would be solved relatively easily.

Unfortunately, I think Trump administration, to a certain extent, and Biden administration adopt sort of policy of containment rather than engagement. I think this kind of policy is entirely wrong, and it will not be successful. For example, so called "small yard, high wall" policy actually is a total failure. As Fred once mentioned, this kind of policy actually are encouraging, even forcing China to work harder on their own. Actually, this is what happened and China has been quite successful over the past few years in making some very important progress. Huawei is a very good example. America wants to kick Huawei out of a global supply chain, but China is a very big economy, and China has a

very comprehensive economic system and hundreds millions of hard working workers. So we'll be able to overcome all these problems.

I think the result of this "small yard, high wall" policy is not good, either for China or United States. At most, you can achieve so-called Pyrrhic victory. Both sides suffer from this. Maybe China will suffer more, but also for United States. Hopefully new administration will change this policy. They should accept Fred's suggestion to strengthen the Sino-American cooperation. I think Fred's proposition of a conditional competitive cooperation is an acceptable approach. Personally, I agree that. I think that there should be no problem for China to accept that.

Fred sometimes criticizes China's compliance of WTO rules and so on. Some of these criticism, I think, are fair. But we should remember the comments made by a former secretary general WTO Lamy. He said that China really, really has done well in terms of a long list of commitment. No country is beyond the criticism. China is not perfect, for example, in terms of opening up a service sector, in terms of protection of IT, so on and so forth. China has problems, but I think we can negotiate under the framework of WTO, and that's very important.

US over the past few years are not that supportive to WTO. I hope US government will stop obstructing the function of WTO. If you think there's something wrong with the China's compliance, then you can sue China. It's not a problem. Then we negotiate. If we have done something wrong, we make corrections. So if both sides realize, in a cooperative way, as two biggest powers in the world, our responsibility for global peace and prosperity, then definitely we can solve all problems.

Yang Yanqing: Thank you, Professor Yu Yongding. You mention that the trade embargo, and also export control and tariff are counterproductive. At the same time, WTO is still a good place to solve the questions. We can discuss on that later. As economists, I would like to ask Professor Yu's view and also Dr. Bergsten's view on the industrial policy. Do you think industrial policy is a good tool for a country to deal with the

economic growth issue and also international economy issue? Please share your views.

C.Fred Bergsten: Let me start by commenting on two things that Professor Yu said, and then I'll go to your question.

Firstly, on his criticism of the containment strategy of the United States, I agree with him. China is too big, too dynamic, too important, too closer a partner in the global economic system to have any hope that containment would work. I totally agree it's a feudal policy. Even if it was feasible, it would not be a wise policy.

When I suggest this competitive cooperation approach and the functional decoupling component of it, that's what I'm trying to overcome. I'm trying to overcome the widespread view in the United States that containment is both desirable and feasible. I think it's neither desirable nor feasible, but you then have to have something in its place. And that's where I believe the functional decoupling strategy would work and would be a very plausible alternative and a much more promising one than continuing down this path of attempted containment, heading toward a "new cold war" and all that.

Then secondly, on the trade issues, as Professor Yu knows very well, I'm a very strong supporter of WTO. I think it was a massive mistake for the Trump administration to essentially destroy WTO. They did that by abolishing the dispute settlement mechanism. Now, the Biden administration has not restored it. I have no praise for the Biden administration in that area either. They could have tried to turn it around and I think they could have succeeded, but they did not. I also hope that our new administration would have to be a Harris administration, not a Trump administration, and would restore the operational effectiveness of the WTO.

Now having said that then to go to your question, madam moderator. Industrial policy is not very well covered by the WTO. It tries to cover some aspects of

industrial policy, like state subsidies, but it does not even go very far in that direction. Actually, it was I and my team at the US Treasury Department a long time ago in the “Tokyo Round” of GATT negotiations that negotiated the subsidy code. We got as ambitious a code as we could at the time, but we knew that it was only a partial step toward disciplining the use of industrial subsidies and therefore industrial policies by countries. So as a result, we now have a period where with security concerns very prominent. Countries are engaged in a very aggressive race through industrial policy to improve their positions in a number of high technology sectors, and we’re seeing it in electric vehicles, semiconductors, now AI.

Yang Yanqing: Do you think this industrial policy will work in the United States in terms of chips and in terms of the new technology?

C.Fred Bergsten: The record of industrial policy in the United States is very poor. It has very seldom worked in the past. There are examples where government support has initiated major technological breakthroughs, like the internet, like radar in World War II, but industrial policy as normally understood has not been at all successful in the United States. And my expectation would be that it will not work any better this time. President Biden was successful in getting congressional approval for funding for industrial policy, both in semiconductors and in some clean energy projects. They’re hoping to generate a lot of new investment. But even then, we don’t know if the products will be competitive. And that comes to then the big issue between our countries, or one of the big issues, which is so called overcapacity.

If China is producing a lot of electric vehicles, China may think that simply developing its competitive advantage, whereas the United States and others may say that’s building overcapacity. There’s nothing wrong with building production for export markets and to meet foreign demand, as well as to meet domestic demand. That’s not necessarily overcapacity. However, if that production is substantially promoted to heavy government subsidy, other preferences for domestic

firm and discrimination against foreign firms, then there’s a real problem, which unfortunately, the WTO, even in its good days, was unable to handle. That’s why I put forward functional decoupling. I would hope that, ultimately, the United States and China would sit down, talk to each other about their respective industrial policy, try to be clear on what is legitimate to defend national security reasons and what is not legitimate when it’s purely for economic purposes, and thus it’s protectionism. Thereby conforming a much clearer dividing line between where we will compete and where we will cooperate in the interest of a much more cooperative and constructive relationship and a more functioning world economy.

Yang Yanqing: Thank you, Fred. We need to work on the industrial policy both in United States and China dialog and research, and also in the WTO framework. But there’s also no rules for the for the industrial policy there, and we need to work on that. Finally, Professor Yu Yongding, please briefly elaborate a little bit on the industrial policy and overcapacity.

Yu Yongding: Actually, there are two kinds of overcapacity. One is at macroeconomic level. In China, at macro economic level, China is not suffering from overcapacity. China’s problem is a lack of effective demand. So China has to use expansionary fiscal and monetary policy to stimulate economy to increase the amount, so that we can help to reduce the pressure on exporting sector. In this way, we can help United States and other countries. Actually, this is continuation of all the debate about RMB appreciation. Fred, remember that actually we were on the same page. A chronic current account surplus is not good for China. It’s not in the long term interest of China. But this is another issue.

Now we are talking about the overcapacity with regard to EV, lithium battery, so forth. We really suffer from this sort of a sectoral overcapacity, and this kind of overcapacity should be resolved mainly by market. I don’t think the government is so wise that it can decide whether this is overcapacity or that is not overcapacity. The government has no this kind of ability.

Of course, there's a problem with the foreign trade side. But we should separate industrial policy from trade policy, because these are two different issues. I entirely agree with Fred. Basically, WTO is silent on this issue and there's no specific rules. Actually, I checked WTO rules before I come here to check whether there are any specific rules against the industrial policy. I fail to find any one. So we need to do work to complement to add something into WTO rules.

And lastly, I would emphasize that China is a strong supporter of WTO. China has tried its best to follow

WTO rules. And according to USTR report, I read lots of those reports on China's compliance of WTO commitment. Up to 2017, the basic assessment by USTR on China's compliance has been positive. And I also want to mention one important case that in WTO, China has been sued by other countries for 40 times. In all those 40 cases, China lost most of those dispute and is on the losing side. But China followed the decision by WTO, which shows that China is very sincere.

So let's go back to WTO to talk to solve all those problems. 🙏