OPINION

A Historic Opportunity for U.S.-China Ties

By Mark Schwartz

Given the recent news on U.S.-China relations, one might think the dialogue between Washington and Beijing has come to a standstill. But look again and a more optimistic picture emerges, one where a trillion-dollar technology agreement has just been signed, where the leaders of the two countries are planning for a major summit meeting in September, and where both sides are renewing efforts to seize one of the most important market-access opportunities to emerge since the two nations normalized relations more than 40 years ago.

> A Bilateral Investment Treaty could give China the modernizing boost it needs, and draw the world's two largest economies closer together.

There are lots of reasons for the U.S.-China Bilateral Investment Treaty (BIT) negotiations to return to the spotlight. On the U.S. side, a focus on accessing China's markets needs to closely follow the anticipated conclusion of the 12-nation Trans-Pacific Partnership negotiations, which, for now at least, excludes China.

On the Chinese side, the BIT could help tame China's volatile stock market. The Shanghai and Shenzhen exchanges saw prices more than double between this past November and June. Then they plunged by a third amid panic selling and heavy market intervention.

While not conceived of as a tool for financial-market reform, a U.S.-China BIT could help modernize China's regulatory system and deliver what China's domestic markets urgently need: deeper and more diverse capital flows and a shift from household ownership to institutional ownership.

The advent of the Shanghai-Hong Kong Stock Connect in November, which created a bridge for trading certain stocks on the two exchanges, has been a huge stride in the right direction. But more liberalization is needed.

A BIT agreement could accelerate the opening of market access to foreigners. That in turn would lead to a more diverse investor base and potentially less volatility. Greater institutional participation, through pension funds and other asset managers, would bring with it long-term investment and a more disciplined fundamental analysis. That's in stark contrast to the current approach taken by retail investors, who account for about 80% of turnover on the Shanghai and Shenzhen exchanges.

The decline of direct household ownership in stocks and a rise in institutional ownership has been central to the development of the U.S. stock market over the past 60 years. More recently, South Korea and Taiwan have seen the development of a domestic institutional-investor base and a rise in foreign institutional ownership that coincided with reduced volatility and lower valuation extremes. Korea's three-year price volatility when markets opened in 1992 averaged 25%. Today it's 13%. Meanwhile, foreign ownership has grown to 32% from 6% over the same period. China may never see foreign ownership on such a scale, but even a more moderate change could accelerate a shift to a more stable capital-market structure.

BLOOMBERG

MUTUALLY BENEFICIAL President Xi Jinping, left, and President Barack Obama.

In giving more access to U.S. investors and Wall Street firms, a BIT would unlock additional U.S. investment in financial technology, tools and techniques. Other foreign firms would quickly follow, as the treaty would soon trigger additional market-opening reforms. Importing more global innovation would help deliver better financial products, allowing Chinese investors to participate in their country's broader economic growth and providing them with attractive alternatives to boom-bust stock-market cycles. A wider range of financial products, including derivatives, would also ensure that China could become a center of investing sophistication and excellence in its own right.

Risk-management practices would also be improved. As financial risk is better priced, markets would be better equipped to transfer risks to those best suited to bear them. Importantly, those same risk-management tools would help develop an expertise in consumer credit, a skill that is critical to a country seeking to make the transition to a consumer-led economy.

The philosophy behind a U.S.-China BIT and the benefits that such an agreement would bring complement and contribute to China's overall reform strategy. Opening up the market to more foreign investment would boost the quality and productivity of the capital available to private firms—especially small- and medium-size businesses—thus freeing them from an overreliance on informal lending. It would help the country transition away from heavy industry to more balanced growth, including household consumption. Foreign capital could also help usher in healthy competition and lead to improvements in efficiency at state-owned enterprises and other businesses, making them better suited to compete in the global marketplace.

Ultimately, China's growing participation in the global economy would mean increased outward investment, which the U.S. needs to attract. Giving Chinese investors the confidence to enter the U.S. market could draw an even larger share of the $55 billion China made in foreign direct investment during the first half of this year. These investments are increasingly coming from smaller, private, entrepreneurial companies, creating investment flows and American jobs in unexpected and underinvested places. Innovative Chinese companies such as Wanxiang and Nanjing Zijin-Lead Electronics are already going global, bringing investment and creating jobs and economic vitality in Elgin, Ill., and Dothan, Ala.

While China and the U.S. remain at loggerheads on many political issues, there's no other existing dialogue between these two countries that could bring about such significant benefits and in such a comprehensive manner. There are many challenges left to overcome. Differences on national security, cybersecurity and intellectual property are formidable and not easily resolved. But both sides must harness the momentum and progress they've achieved so far and not let go of this historic opportunity to more closely link together the world's two largest economies.

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