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The Fallout of Phase One:

What the Trade Agreement between the United States and China means

By Bert HOFMAN

"America is winning like never before", US President Donald J Trump said in Davos at the 2020 Annual Meeting of the World Economic Forum and as exhibit one he offered the trade agreement with China. If one counts the commitments made from both sides, he was right to claim that the United States has clearly won this round.

After nearly two years of trade talks, threats and escalating tariffs imposed on bilateral trade, on 15 January 2020 the United States and China signed an "Economic and Trade Agreement" (the Agreement). The Agreement has 96 pages, 8 chapters, 67 articles and numerous annexes that provide more details on areas ranging from agricultural imports by China to "Bilateral Evaluation and Dispute Resolution".

As trade agreements go, this one is remarkably one-sided. The document contains a total of 105 commitments by China ("China shall"), compared to 88 joint commitments ("Parties shall") and only five commitments by the United States ("the United States shall"). In most clauses, the United States simply "affirms" that its existing policies already meet the requirements of the article in the Agreement.

The agreement leaves the tariffs imposed thus far largely in place (Figure 1); only the 15% tariffs on China's $150bn export imposed in September 2019 was reduced to 7.5%, a rather meagre step back towards normal. In addition, the tariffs on another $180 billion of imports from China, which had been announced to take effect mid-December 2019, were not imposed.

WHY DID CHINA SIGN?

First, the agreement commits China to a number of steps that solidify its ongoing reforms in intellectual property (IP) protection, technology transfer and the financial sector. The reforms committed are already in place, but tying these to an agreement with the United States can reinforce the impact of reforms. This will further improve China's business environment, make it a more attractive place to invest in new technologies, and over time, improve the efficiency of investments made by a more diverse financial sector.

Second, the agreement may lead to some calm and lower policy uncertainty, which would help China's growth at a time when the domestic reform agenda may slow it down. Indeed the International Monetary Fund (IMF), in its WEO Update, upped its growth projection for China by 0.2 percentage point for 2020, largely on the basis of the reduction in uncertainty due to the trade agreement. Calm is not a given: The

Agreement itself provides for further negotiations and President Trump seems keen to start negotiating Phase 2 right away. The Trump administration is also turning its attention to others, including the EU and the UK, so calm on the broader trade front may remain elusive.

Another explanation doing its rounds is that China's reformers won the internal debate and were able to use the trade agreement to achieve reforms they could not have achieved without outside pressure. This may have been true a few years ago, but since then China has already acted on a number of areas stipulated in the current Agreement, including IP protection, technology transfer and financial services. What the agreement does is tilting the playing field towards US companies at the expense of other foreign companies and tie China down on more specific measures. Whether on net this is a gain for the reformers remains to be seen.

A fourth explanation for China's willingness to sign up for this Agreement is that in the past two years of trade tussle China has come to realise that the ultimate aim of the United States is decoupling, containment and slowing China down. The trade dispute has revealed China's dependence on the United States for key foundational technology and its need for more time to prepare for an unavoidable confrontation down the road. Thus, the agreement was signed to buy time.

Irrespective of which explanation holds true, the unbalanced nature of the Agreement is striking. The commitments that China has made in terms of structural reforms are not matched by any agreement to reduce the tariffs already imposed, either now or within the foreseeable future. Nor does the agreement touch on other measures that the United States has recently imposed on China. These include the "entities list" on which Huawei and some 28 other companies have been placed in the course of the trade dispute; the sharper CFIUS (Committee on Foreign Investment in the United States) rules aimed at further reducing China's FDI (foreign direct investment) in the United States; and the export restrictions for national security reasons that Chinese companies increasingly face.

A modest "win" for China is the removal of China from the US Treasury List of Currency Manipulators. The US Treasury had put China on that list last August, a move that surprised many, as China had long given up on its policy of intervention to keep the currency weak. Instead, since the onset of the trade war with the United States, China had been intervening to keep the currency strong, not weak. Whatever may have been the case, the designation as currency manipulator did not mean much when it happened, neither does the abolition of this designation.

THE CONSEQUENCES OF MANAGED TRADE

China agreed to increase purchases from the United States by $200 billion in the coming two years. President Trump at Davos mentioned that it could be even as high as $300 billion. Oddly, this is not a number to be added to China's overall imports of about $2.2 trillion in 2017, the "baseline year". Nor is the $200 billion in addition to China's total 2017 imports from the United States of $180 billion. The increased imports are for a subset of goods and services imported from the United States, amounting to some $130 billion in 2017 (Figure 2). This narrow definition of what import counts makes it harder for China to meet the targets. It probably reflects more effective lobbying by special interest groups within the United States than anything else.

The commitment to import more will be even harder to meet, because since 2017 imports of China from the United States have declined, as Chad Bown of the Peterson Institute of International Economics, one of the keenest observers of the US-China trade conflict pointed out here. Thus, China will have to increase its imports from the United States by over US$240 billion in the next two years to meet the agreed target. Finally, because of the troubles at Boeing, this usually major import category for China is left out of the agreement, making it even harder for China to meet the agreed purchases.

Because the categories of goods to be imported are so narrowly defined, it will affect the exports of other countries to China. Specifically, in the area of commodities, countries such as Brazil, Russia, Canada and Australia are likely to lose out. In manufacturing, Europe, Japan and Korea stand to lose from China's increased imports from the United States. EU Trade Commissioner Phil Rogan expressed his concern on the agreement and the consequences for the EU's exports to China.

Moreover, as the tariffs on China's exports to the United States are not affected, China's exports are likely to continue to be diverted to other destinations. In 2019, for instance, though China's overall exports were down slightly, and those to the United States were down some 15%, those to ASEAN and the EU were up sharply (Figure 3). Of course, some of those countries are doing better in their exports to the

United States because of the tariffs imposed on China's exports to the United States. Europe, Canada and Mexico are clear winners (Figure 4).

The agreement on the additional imports is in all likelihood against the WTO's (World Trade Organisation) most basic rule of "Most Favourite Nation", or MFN. MFN entails that members should treat all other members at the most favourable terms granted to any. Exceptions can be made: countries are allowed to set up a free trade agreement that applies only to goods traded within the group, but only with strict conditions, including the condition that the agreement is broad-based (i.e. comprising most of the trade in goods and services). The US-China agreement clearly does not meet WTO conditions. While the agreement includes a clause stipulating that "purchases will be made at market prices based on commercial considerations", the US side has left little doubt that it wants to see the extra sales. For China, it would probably mean directing companies to buy from the United States, thus reversing some of the progress made in market reforms.

AGRICULTURE AND FOOD SAFETY STANDARDS

The Phase 1 trade agreement pays particular attention to agriculture—again largely skewed towards China's commitments to open up to US agricultural exports. The chapter contains only one article, but contains 17 annexes that define in detail US producers' increased access to the Chinese market. Most remarkable in the agreements on agriculture is China's unilateral recognition of the US food safety regulatory system—without reciprocal treatment by the United States.

Reciprocal recognition of standards in not unusual in trade agreements and it is a key component of economic unions such as the EU, a fact the UK is finding out now that it is leaving the Union. Unilateral recognition is rare. Of course, it is fair to argue that the US food safety system, backed by its strong liability laws, is in better shape than China's, but the fact that China waives its rights to enforce its own system is remarkable indeed.

The agreement notes that the parties reserve their rights under the WTO. With the US-instigated demise of the Appellate Body of the WTO in December, this clause has lost its meaning, as cases can be suspended in appeal forever.

EVALUATION AND DISPUTE RESOLUTION

The Agreement contains a chapter on Evaluation and Dispute Resolution. The implementation of the agreement falls under the "Trade Framework Group" to be led by the US Trade Representative (currently M. Lighthizer) and "a designated Vice Premier" of the PRC. The parties also agree to resume "macroeconomic meetings" to discuss overall economic issues. This meeting, which resembles the Strategy and Economic Dialogue of the past, is led by the US secretary of the treasury (Secretary Mnuchin at the moment) and a designated vice premier. Though it remains to be seen how important this broader macroeconomic dialogue will be, it could become a vehicle for agreeing on areas of common concern.

Disputes on a lack of implementation of the agreement will go through consultations at various levels before the complaining party can impose "remedial measures in a proportionate way" if disagreements persist. These measures are presumably to be determined by the complaining party alone. The most likely "remedial measure" will be tariffs. Due to the highly skewed distribution of commitments, China is more likely to miss a commitment than the United States and thus more likely to be on the receiving end of "remedial" tariffs.

Of particular note is the fact that retaliatory tariffs are not allowed even when one of the parties disagrees with the remedial measures of the other. The only counter-remedy allowed is to cancel the agreement altogether, which would bring the United States and China back to the standoff they were in before the Phase 1 agreement.

Remarkable, too, is the lack of a mechanism for regularly reviewing the tariffs already imposed. Even if both parties are to fully fulfil the agreements made, the Agreement provides no guarantee that tariffs will be cut. Instead, this will remain at the discretion of the parties. From comments made by the US side, they are in no hurry to reduce the tariffs and indeed it seems highly unlikely that this will happen before the US elections in November.

WHAT NEXT?

Despite the legal substance and format of the agreement, the Trump administration had earlier argued that this is not a treaty in a legal sense. Thus, it is expected that the US Senate will not be required to ratify it and therefore it has de facto come into force.

The bottom line of the agreement is that China is creating a better environment for technology and intellectual property dependent industries, which are more likely to invest in China. The United States can sell more goods to China in return, particularly agriculture produce and energy. The bilateral trade deficit of the United States with China is likely to go down due to the commitment of China to buy more and the continued effects of tariffs imposed on China's exports.

Overall, though, the US trade deficit will not go down because of this agreement: trade deficits depend on macroeconomic policies, not trade policies. All signs are that the United States, which has been running a trade deficit since 1974, will do so for years to come. Moreover, the tariff war does not seem to have achieved what the United States has set off to attain: revamp manufacturing. A working paper by staff of the US Federal Reserve Board finds that US manufacturing industries more exposed to tariff increases experience relative reductions in employment as the positive effect of import protection is offset by larger negative effects from rising input costs and retaliatory tariffs.

To minimise the impact of the tariffs, China can decide to further lower tariffs on imports from other countries, a policy it had implemented in 2018 and 2019 to offset some of the negative effects of the tariffs it imposed on the United States. However, this policy is now constrained by the commitment to buy more from the United States.

As for the next phase of negotiations, it will have to address issues of industrial policy, state-owned enterprises and subsidies—highly contentious issues that did not make it in Phase 1. The latest report of the World Bank and the Development Research Centre of the State Council, *Innovative China,* provides some suggestions on how this could be handled. Of course, it would have been great if new rules on such important issues were to be agreed as part of WTO reforms. Alas, multilateralism was the first victim of the war, and given US success in its bilateral approach, a return to multilateralism is a distant dream for now.

A glimpse of what the United States expects China to agree on in Phase II can be found in the "Joint Statement of the Trilateral Meeting of the Trade Ministers of Japan, The United States and the European Union". This statement bluntly states that the WTO policies on subsidies fall short and that the WTO appellate body has been too lenient on the issue of subsidies and state entities in the past, and that both need fixing. Though China is not mentioned, it is clear that the country is the main target of such fixes.

Expect therefore more fireworks in the Phase 2 negotiations. Happy year of the Rat!

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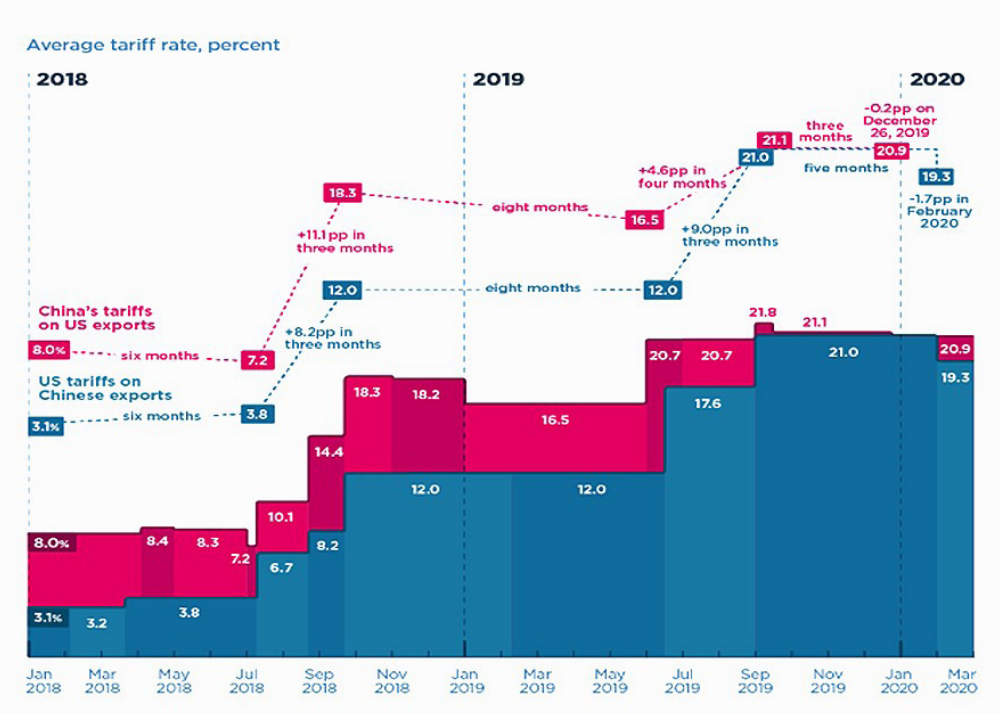
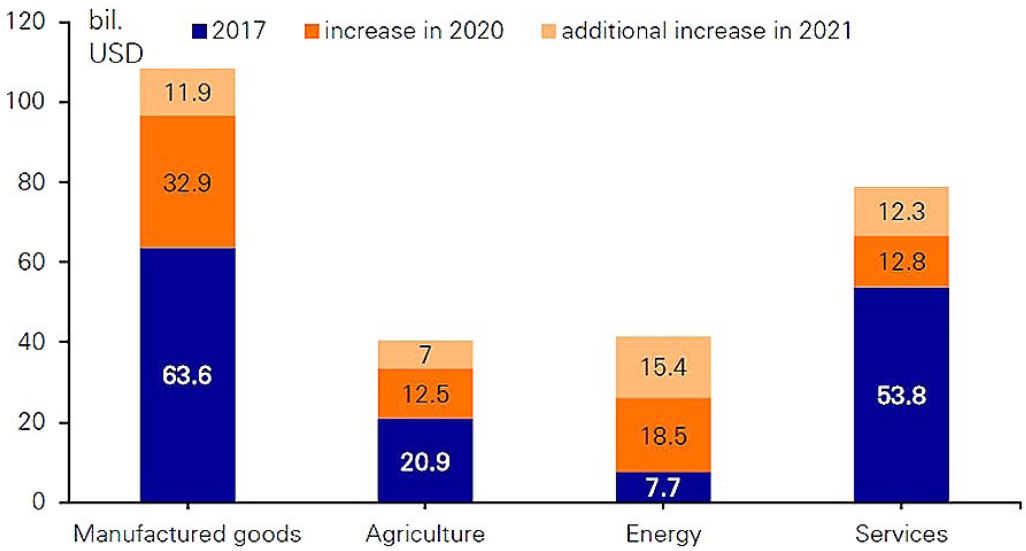
FIGURE 1 THE PHASE 1 AGREEMENT BARELY REDUCES THE TARIFFS ALREADY IMPOSED



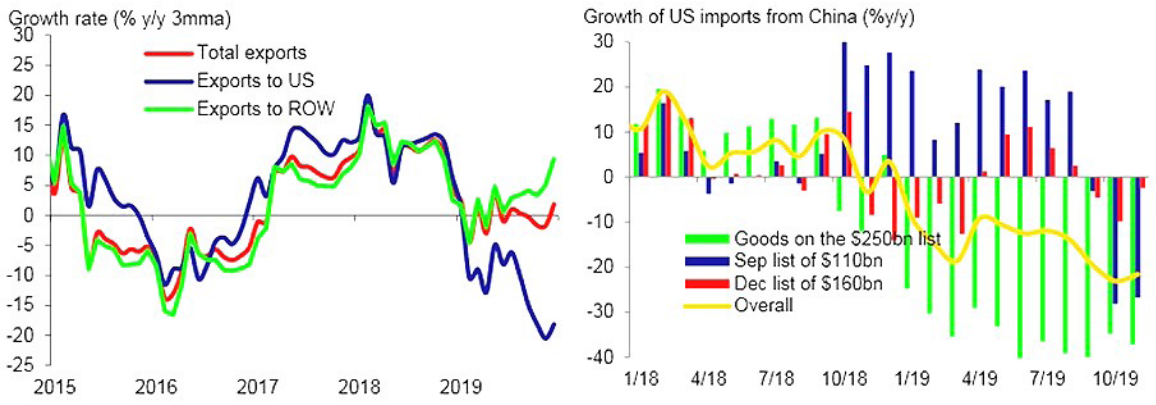
Sources: Chad Bown, PIIE.

FIGURE 2 AGREED ADDITIONAL $200 BILLION IMPORTS OF CHINA FROM THE USA



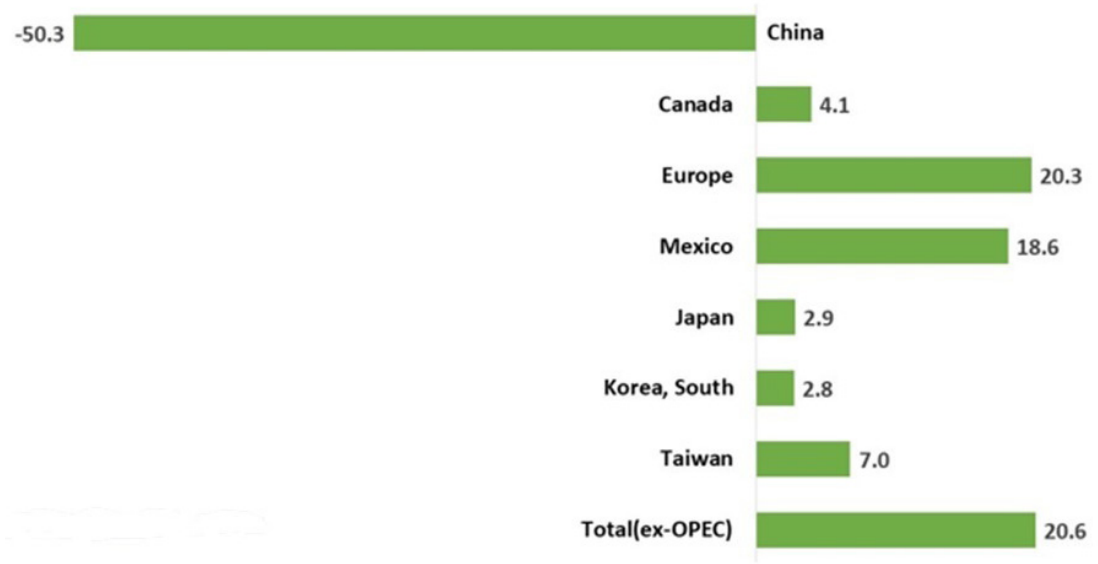
Sources: Deutsche Bank.

FIGURE 3 CHINA'S EXPORTS TO THE UNITED STATES DOWN IN 2019, BUT UP FOR OTHER COUNTRIES



Sources: UBS.

FIGURE 4 TRADE DIVERSION AT WORK: CHANGES IN THE CONTRIBUTION TO THE US TRADE DEFICIT, JAN-OCT 2019 VERSUS JAN-OCT 2018, US$ BN



Sources: Brookings/David Dollar.