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U.S.-CHINA TRADE DEAL: THE EASY STEP IS DONE. AND NOW?

U.S.-Chinese "phase-one deal": Ceasefire in the trade war, but nothing more. Tariffs remain much higher than they were. What's next?

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IN A NUTSHELL

- China is committed to importing significantly more from the United States, opening up its financial market to foreign investors and improving protection of intellectual property rights. In return, the United States will waive further tariff increases and withdraw some of the punitive tariffs it had imposed.
- Even after the agreement, tariff rates remain substantially higher than before the crisis. The main points of contention – above all, competition-distorting Chinese subsidies – remain unresolved and the subject of future negotiations.
- Though tariffs remain high we expect a positive impact on growth in both countries compared to last year, thanks to reduced uncertainty.

There were no surprises in the American-Chinese "phase-one deal" signed on January 15. China commits to substantially increasing its imports from the United States (200 billion dollars more over the next two years compared to 2017 figures), opening up its financial markets to foreign investors, respecting intellectual property rights, and refraining both from forcing foreign companies to transfer technology and from currency manipulation. In return, the United States has already suspended further planned tariff increases in December and will halve the tariffs on 120 billion dollars of certain U.S. imports from China, from 15% to 7.5%.

WHAT ARE THE ECONOMIC IMPACTS?

The average tariff rate on bilateral trade is still significantly higher than before the trade conflict. Until the beginning of 2018 China paid an average of three percent customs duty on exports to the United States, while the United States paid an average eight percent tariff on its exports to China. Both countries now face an average tariff burden of around 20% in their bilateral trade. This is unlikely to change much as a result of the new deal. We nevertheless expect the deal's impact to be positive for growth in both countries. In 2019 the high level of trade uncertainty hurt both demand and investment and therefore had a greater negative impact on economic activity than the customs duties themselves. The U.S. economy should also benefit now from the substantial increase that has been agreed in Chinese imports from the United States.

THE MORE DIFFICULT ISSUES HAVE BEEN POSTPONED

However, and despite the fact it has taken more than two years to conclude the "phase-one" agreement, only the least controversial items have been resolved. Market opening is in fact part of China's long-term structural reform plans and, like respect for intellectual property rights, is seen as important for China's internal development. There are, however, far more contentious and controversial issues to be addressed and, according to the U.S. government, they will be part of a follow-up agreement ("phase two") on which negotiations are unlikely to begin before the U.S. elections. These more sensitive issues are the ones China is reluctant to address: global technology leadership, state subsidies and political conflicts.

THE COMPETITION FOR GLOBAL TECHNOLOGY LEADERSHIP

The more difficult issues relate mostly to the competition for global technology leadership. Each side wants to be in first place in the major industries of the future, and especially in artificial intelligence. And this battle is likely to provide a motive for further mutual non-tariff trade barriers. On the U.S. side there are certainly legitimate security concerns about the use of Chinese technological equipment in sensitive areas of the military and national security. But such concerns are sometimes used to mask efforts to curb unwelcome foreign competition.

This conflict has so far been most visible in the way the United States is dealing with the Chinese telecommunications giant, Huawei. Like many other Chinese technology companies, it is subject to a de facto ban on parts deliveries from U.S. companies. However, as many U.S. companies generate substantial revenues from sales to Huawei, the ban has been postponed several times – for example, from August to November 2019 and on November 19 for another three months. The U.S. Treasury Secretary Steven Mnuchin has stressed more than once that Huawei is not an obstacle to a trade agreement.

CHINESE STATE SUBSIDIES DISTORT RELATIVE COMPETITIVENESS

The most difficult issues go deeper still. Extensive Chinese subsidies of various kinds (from cheap loans to lower-priced energy and raw materials) have contributed to Chinese technology companies' now dominant global position. State subsidies that distort relative competitiveness and the largely state-supported long-term development strategy, "Made in China 2025," which promotes key industries, are increasingly being criticized from abroad. Europe and Japan also want the United States to address these issues in the context of the enforcement of World-Trade-Organization (WTO) rules. However, technology promotion represents a "red line" for China. Criticism of the policy is seen as an interference in state affairs.

POLITICAL CONFLICTS

Political and geopolitical disputes between the United States and China are also sources of tension that could potentially lead to economic sanctions. For example, the Hong Kong Law – a cross-party initiative to support Hong Kong's fight for democracy and to encourage anti-government protests in Hong Kong – has led China to threaten retaliation. China's treatment of the Uighurs, a Muslim minority in the Xinjiang region, is also being criticized by the United States and other countries – and China calls this, too, interference in its sovereign affairs.

WHAT IS THE RISK SCENARIO?

If bilateral negotiations fail again, followed by the imposition of further U.S. tariffs on China, Chinese retaliation is to be expected. China's preferred measure would probably be non-tariff actions focused on individual companies, according to China's so-called "unreliable entity list." Targeting U.S. companies that produce and sell in China would have a greater negative effect on sales and profits than punitive tariffs. On the American side, too, new possible sanctions are reportedly being explored – for example, a ban on U.S. citizens working in the Chinese financial market or a reduction in the weighting of Chinese securities in international benchmarks. A spiral of negative sanctions would be negative for both countries and would have serious consequences for global trade, supply chains and financial markets.

CONCLUSION: A PAUSE IN HOSTILITIES

A ceasefire in a trade conflict does not imply the war is over in all areas. We do not expect a comprehensive follow-up agreement (phase two) in the foreseeable future. We do, however, expect the planned regular consultations between the United States and China to be of great importance. This is where the hardest work will have to be done and compromises have to be found. Mini-steps – compromises on critical issues and very gradual tariff withdrawals – seem far more likely than a high-profile, comprehensive "phase-two" deal.

GLOSSARY

The U.S. dollar (USD) is the official currency of the United States and its overseas territories.

The World Trade Organization (WTO) is an international organization based in Switzerland, which regulates commerce between nations through mutually agreed rules.

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