Insight

The Details of Trump's Phase One Trade Deal with China

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Executive Summary

- The United States and China signed a "Phase One" trade agreement last week, ceasing the trade war escalation of the past year and a half—at least in the near term.
- Taken at face value, the trade agreement takes significant steps to reform Chinese trade practices such as forced technology transfer and intellectual property theft and reduces non-tariff barriers to U.S. exports.
- The dispute resolution system, however, calls into question whether these provisions can be effectively enforced.

Overview

President Trump and President Xi of China signed a "Phase One" trade agreement, a deal the United States and China have been negotiating since December 2018. Contrary to prior belief, the agreement goes beyond increased Chinese purchases of American agricultural goods and tackles significant issues such as forced technology transfer, intellectual property protections, and non-tariff barriers to U.S. exports. Unfortunately, the ability for the United States to enforce these provisions leaves something to be desired.

The agreement, set to go into effect on February 14, has seven chapters covering intellectual property, technology transfer, agriculture trade, financial services, currency issues, dispute resolution, and expanding Chinese imports.

Section-by-Section Analysis

One of the most notable provisions of the Phase One agreement is a ban on forced technology transfer – a common practice in China that requires U.S. companies to share their technology with Chinese firms in exchange for market access. The deal also prohibits China from making strategic investments in U.S. firms, not for economic reasons, but for the purpose of acquiring technology.

The chapter on intellectual property is especially comprehensive. China agreed to criminal enforcement against trade secret theft, including corporate espionage, and agreed to reduce counterfeiting by blocking the online distribution of counterfeit goods and increasing inspections at the border. China also agreed to strengthen the protection and increase the availability of patents, including pharmaceutical patents.

In agriculture trade, China agreed to reduce non-tariff barriers that inhibit U.S. exports of beef, poultry, dairy, and other agricultural products. One example is sanitary and phytosanitary measures. While these regulations intend to protect consumers from diseases and contaminants in food, they are akin to trade barriers if they are too restrictive. The Phase One trade deal ensures that any regulations of this kind are non-discriminatory and based on science.

China agreed to be more transparent in its enforcement of tariff rate quotas (TRQs) – a trade barrier that applies lower tariffs to a certain quantity of imports and higher tariffs to imports above the quota. Previously, China did not allow fair imports under TRQs; instead it artificially limited its imports so that the quotas were never reached. For this reason, the United States brought a lawsuit against China at the World Trade Organization (WTO) in 2017, a case that China lost. The new trade agreement requires China to uphold its WTO commitments by being transparent and fair in its management of TRQs.

China also agreed to be transparent about its subsidies to the agricultural sector, essentially agreeing to adhere to a separate WTO ruling. It is worth noting, however, that due to steps taken by the Trump Administration, the WTO will no longer be able to enforce rulings like this moving forward.

The financial services chapter includes Chinese commitments to lower barriers to U.S. financial services providers such as banks, insurance companies, and electronic payment providers, opening its financial industry to foreign ownership. These market-oriented provisions are undoubtedly positive, but many of these Chinese reforms were in the works before the trade agreement was signed.

Up to this point, the Phase One agreement takes great steps to institute much needed market-oriented reforms in China. The chapter on currency manipulation, a new feature of trade agreements under the Trump Administration, is not as valuable. This chapter states that neither the United States nor China may competitively devalue its currencies to gain an advantage in global trade and both must respect each other's independent monetary policy decisions. Separately, the Trump Administration reversed China's formal designation as a currency manipulator, a designation it made just five months ago.

Provisions against currency manipulation are intended to combat China's long history of currency manipulation, albeit a phenomenon that hasn't occurred since China abandoned its dollar peg in 2005. If enforced, however, provisions like these could infringe on the United States' ability to use monetary policy as a tool against economic downturns, depending on the definition of a "competitive devaluation."

The penultimate chapter on expanding trade is arguably one of the deal's most controversial. The chapter contains specific pledges from China to purchase $200 billion of additional goods and services (over 2017 levels) from the United States over the next two years. Reaching this goal would necessitate a 150 percent increase in Chinese purchases over 2017, or a 170 percent increase over a five-year average, an increase that cannot possibly reflect market demand. More likely, this chapter was negotiated in hopes that the Chinese government would exert its central control to force an increase of certain imports from the United States – a trade distorting activity that will likely raise costs for Chinese consumers. The agreed increase will be on U.S. exports such as machinery, vehicles, agricultural products, crude oil and coal, financial services, and even Chinese tourism to the United States.

Enforcement

The crux of this deal is in its final chapter, which creates a new dispute resolution system between the United States and China. Enforcement is particularly important given the lofty reforms China agreed to around strengthening intellectual property protections and ending forced technology transfer – especially considering that China agreed to similar reforms in the past but did not follow through with them.

If either the United States or China violate the provisions of the Phase One trade agreement, the enforcement chapter outlines a series of negotiations to take place. These negotiations would start with designated trade officers of both nations and, if unresolved, work their way up to the U.S. Trade Representative and Chinese Vice Premier. In the case that a dispute cannot be resolved through bilateral negotiations, the complaining country would have the right to enact proportional trade remedies (most likely tariffs) without the threat of retaliation as long as the remedies were taken "in good faith." If the accused country does not view the other's remedies as "in good faith," it has the right to withdraw from the agreement.

Any trade deal is only as good as its enforcement mechanism. It is questionable whether an enforcement mechanism based entirely on bilateral negotiations will be successful. Traditionally, trade disputes are handled by a neutral panel of experts, not by trade negotiators from countries engaged in the dispute. This structure helps to ensure that trade disputes are resolved and that their outcomes can be effectively enforced. The United States and China instead decided to resolve issues on their own, something they have not been able to do since the trade war began. If either country does not like the actions of the other and is unwilling to come to a compromise, the most likely recourse would be either more tariffs or trade agreement withdrawal.

Reduced Barriers, Uncertain Outcomes

This Phase One deal with China is an example of how trade agreements can be used to lower trade barriers both at home and abroad. Not only did China agree to significantly reduce its non-tariff barriers against U.S. exports and begin to reform some its unfair practices, but the Trump Administration will also reduce a portion of its latest unilateral tariffs on China. At the same time, the weak enforcement mechanism calls into question whether China will adhere to its promises. Only time will tell.