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INSIGHT

U.S. Announces Preliminary Phase One Trade Deal with China

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The Trump Administration announced on December 13, 2019, a draft agreement with the Chinese government on a subset of trade and investment issues the Administration raised in March 2018 under Section 301 of the U.S. Trade Act of 1974. The Chinese government has not formally agreed to the agreement and neither side has signed it. China is currently reviewing the text, leaving open the potential for disagreement or renegotiation of terms. If the process goes smoothly, U.S. Trade Representative (USTR) Robert Lighthizer and Chinese Vice Premier Liu He could sign the agreement in January 2020 in Washington, DC, before starting phase two negotiations.

The Administration identified four concerns about China's behavior in its March 2018 Section 301 Report—forced technology transfer, cyber-enabled theft of U.S. intellectual property (IP) and trade secrets, discriminatory and nonmarket licensing practices, and state-funded strategic acquisition of U.S. assets—and subsequently imposed four rounds of tariffs on Chinese goods. China responded with four rounds of counter tariffs. Negotiations also sought to address President Trump's concerns about the trade balance and incorporate Chinese offers in unrelated areas, such as financial services.

The USTR said the two sides have drafted an 86-page text covering some aspects of IP, technology transfer, agriculture, financial services, exchange rates, and dispute resolution that could be made public over the next few weeks. The two sides have been working with a draft text since at least May 2019, when China reportedly returned a heavily marked up draft and held up purchase agreements until the United States agreed to lift some tariffs. The Administration may have released details of the draft agreement to justify its decision to delay tariffs scheduled to take effect on December 15 and to lock in terms with China.

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Reactions

Some Members of Congress and most commentators assess the deal to be a first step in a longer effort to resolve U.S. trade concerns with China. Many observers call it a short-term truce, noting it falls significantly short of the Administration's goal of a comprehensive settlement, leaving tough systemic issues on IP and technology transfer to phase two talks. The USTR agrees that the deal is just a first step, but notes that most U.S. tariffs remain in place and that the deal will have a strong enforcement mechanism. Critics counter that the Administration was too quick to settle and that by lifting and delaying some tariffs, it may have lost leverage. They see the Administration as responding to pressure to keep China relations stable and the U.S. economy on solid footing ahead of the U.S. presidential election in November. U.S. firms, especially smaller companies, facing tariffs that remain in place are still concerned about the effects on their businesses. Others note that China's promise to buy an additional $16 billion in U.S. agriculture in the deal's first year is well below the U.S. target of $25 billion. Beijing also has preserved space for China to implement its industrial policies in strategic sectors of concern to the United States. Critics argue the timing gives China credit for purchases of U.S. products it would have likely made anyway in areas such as pork, to address shortages ahead of the Chinese lunar new-year in late January, and stem inflationary pressures.

Key Details and Issues to Watch

Tariffs. The United States agreed to delay tariffs scheduled to take effect December 15, 2019, that would have affected approximately $160 billion worth of imports from China, particularly consumer electronics. For U.S. tariffs enacted on September 1, 2019, the deal cuts the tariff rate from 15% to 7.5%. The remaining U.S. tariffs enacted since March 2018 will remain in effect. According to a December 15 announcement by China's State Council Tariff Commission, China has agreed not to proceed with its own scheduled December tariff increases (Appendix II) and will extend exemptions for autos, auto parts and some pork and soybean imports it announced in September; earlier tariffs, including tariffs China implemented on September 1 (Appendix I), remain in effect. Some question whether the deal will be enough to reassure business and supply chains that have been diversifying in the wake of tariffs.

Purchases. China committed to purchase an additional $200 billion of U.S. agriculture, energy, and manufacturing goods over the next two years, with a detailed breakout by commodity; agriculture constitutes approximately $40 billion to $50 billion of the total. Beijing said it will buy $16 billion of U.S. agricultural goods in the first year of the deal and that purchases will be market-based, which may mean Chinese purchases could fall below U.S. stated goals. China's purchases may potentially shift U.S. export flows from other markets but not generate new demand. Neither side has released details about commitments beyond year two.

Currency. The Administration negotiated a currency commitment similar to Chapter 33 of the proposed U.S.-Mexico-Canada Agreement that includes a commitment to market-determined exchange rates, transparency and reporting requirements, and recourse to dispute settlement.

Financial Services. China promised to selectively reduce some foreign equity limits and restrictions, likely in an effort to generate pockets of U.S. business support, but may slow implementation through licensing, as it has done previously.

IP. China's commitments on counterfeiting, patent and trademark, and pharmaceutical protections may reflect recent domestic actions. China's new Foreign Investment Law imposes legal penalties for officials who disclose trade secrets, but Chinese industrial policies still incentivize government officials to obtain foreign knowhow. China's State Council promised new IPR protections by 2022, including financial damages in patent infringement cases, but has been silent on industrial policies and procurement rules that require foreign firms to share or transfer IP and knowhow to China.

Technology Transfer. USTR says that China will not force technology transfer and will not use state financing to make overseas acquisitions that advance China's industrial policies. This may be difficult to enforce. The new Foreign Investment Law forbids forced technology transfer, but Chinese officials frequently state that foreign firms willingly give their technology. Chinese industrial policies, such as Made in China 2025 and the national semiconductor policy, remain in force, and the Chinese government can leverage informal powers. The U.S. business community has voiced concerns that China is doubling down on industrial policies, including recapitalization of government funds and the launch of a new plan and $21-billion government fund to support advanced manufacturing. In 2020, Chinese officials will be adjudicating the country's next Five-Year Plan (2021-25) and supporting industrial plans that lay out plans for specific sectors.

Enforcement. USTR says remaining U.S. tariffs will incentivize implementation of Chinese commitments. An enforcement mechanism will allow 90 days to resolve issues, after which either side can take proportionate action. Snapback tariffs may be difficult to justify without specific benchmarks and timelines.

Phase Two. Core U.S. concerns on IP, technology transfer, and state subsidies appear to be left to phase two of the negotiations. These systemic issues have so far been intractable. They involve a web of reinforcing Chinese government plans and industrial policies that offer preferences and support for Chinese firms, both domestically and overseas, and often require foreign firms to partner and transfer technology, proprietary knowhow, and core IP with Chinese entities. China has used dialogue in the past to delay action on contentious issues. Phase two will test whether the U.S. approach can break new ground.

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