INTRODUCTION

The international trading system experienced significant disruption in 2019. Ongoing bilateral tensions, with the mounting tariff war between the United States and China at the forefront, generated considerable market uncertainty. A lesser known clash between Japan and South Korea posed risks to the global technology sector. Some residual negotiations produced tangible results, including a revised United States – Mexico – Canada Agreement (USMCA) and a new U.S. – Japan bilateral deal. At an international level, political tensions at the World Trade Organization (WTO) immobilized the institutional mechanics critical to dispute resolution.

Canadian financial institutions have an imperative to interpret and respond to these macroeconomic changes. Trade negotiations can shape the rules for cross-border financial services, ranging from foreign asset purchases to digital banking and data governance. Trade disputes can increase market volatility while dragging down foreign direct investment. Trade barriers or new agreements can pose credit risks for retail and commercial lenders, as impediments to or new opportunities for goods/services exchange affect intermediate and consumer prices and business competitiveness. To understand their consequences for regulatory compliance, market returns, product lines, and aggregate enterprise risk, financial professionals should first familiarize themselves with the major trade developments of the past year and continue to monitor their trajectories in 2020.

United States – Mexico – Canada Agreement (USMCA)

With its first iteration in the Fall of 2018, the United States-Mexico-Canada Agreement (USMCA) faced ratification in each of the participating countries before coming into force, and U.S. lawmakers subjected the deal to considerable scrutiny. Throughout 2019, the Trump Administration grappled with opposition in the House of Representatives, as Democrats mandated amendments to the USMCA terms in exchange for the necessary implementing legislation (an affirmative vote in Congress is required for approval of many trade agreements, as set forth by Trade Promotion Authority). After more than a year of supplementary negotiations, House Democrats agreed to a revised text in December 2019. Among the list of revisions, United States Trade Representative (USTR) Robert Lighthizer incorporated new environmental and labour measures. A rapid-response mechanism commissions a binational panel for mediating claims of labour rights infringement (one for U.S-Mexico; one for Canada-Mexico). The new text also omitted a previous ten-year minimum data protection for biologic drugs, allowing Canada to maintain its existing bounds under domestic law. A core provision in the November 2018 agreement, the rules of origin assigned to the automotive industry were changed to include stricter requirements for North American steel inputs.

Canada and Mexico conceded to the amendments devised in Washington and representatives of all three parties assembled in Mexico City for a second signing ceremony on December 10th. The Mexican Senate approved the revised agreement on December 12th, while the U.S. House passed it by a 385 to 41 majority vote on December
19th The Senate approved the bill with an 89 to 10 vote on January 16th, 2020. Ratification in Canadian parliament will be the last step before full implementation.

United States – China Dispute

Click here for more on the U.S. – China trade dispute (2018) from the Global Risk Institute.

Bilateral negotiations between the United States and China yielded some resolution in 2019. With respect to the cross-sectoral tariff war, launched in earnest following the March 2018 publication of the U.S. Trade Representative’s Section 301 report, President Trump announced on October 11th that the Administration had reached a tentative “substantial phase one deal” with Beijing pending further drafting. China reportedly conceded to a subgroup of American demands as part of the mini deal, including a commitment to purchase $40 to $50 billion in agricultural goods. In exchange, the Administration agreed to forego a tariff increase on $250 billion of Chinese goods from 25 to 30%. President Trump announced the completion of a finalized text on December 13th, a document the parties eventually signed on January 15th, 2020. The agreement covers a range of U.S. grievances, including intellectual property protections, forced technology transfer, currency manipulation, financial services access, agricultural products and dispute resolution. In total, the Chinese agreed to increase U.S. goods and service purchases over a two-year time frame by at least $200 billion from 2017 levels. In exchange, the U.S. held off on new tariffs scheduled for December 15th and agreed to cut rates on $120 billion worth of imports from China in half, from 15% to 7.5%. Early analysis suggests, however, that the more challenging questions at the centre of the dispute concerning structural reforms to the Chinese economy remain unresolved, including around industrial subsidies and support for state-owned enterprises (SOE); a strategy that could complicate later discussions on these issues. Furthermore, levies of 25% on $250 billion in goods remain in place; a bargaining chip that the president sees as leverage in future talks.

Negotiations for a phase two deal are set to commence immediately, and Trump has indicated that the alleged systemic problems with the Chinese economy will be the primary focus of dialogue. As talks continue through 2020, the recent truce could prove a temporary reprieve, yielding to another flare up in bilateral tensions that increases global economic uncertainty once again.

United States – Japan Agreement

On September 25th, 2019, U.S. President Donald Trump and Japanese Prime Minister Shinzo Abe signed a new bilateral trade agreement. The Japanese committed to reduce or remove tariffs on U.S. agricultural products or provide special import quotas. Goods affected by the changes include (but are not limited to) beef, pork, wheat, walnuts, almonds, cranberries and cheeses. In exchange, the U.S. conceded to tariff reductions on some agricultural and industrial goods. As an addendum to the main agreement, the two parties also signed an accord on digital trade. The side deal sets forth standards on par with those in the USMCA, including provisions on open data transfer, prohibitions against forced data localization (including for financial services) and bans on “arbitrary access to computer source code and algorithms.” Critically, automobiles were not included in the agreement, the sector that comprises the largest share of Japanese exports to the U.S. Trump had previously threatened to impose tariffs on Japanese autos on national security grounds but PM Abe received assurances that the levies would not be imposed with an agreement in force. Given its limited scope, the U.S.–Japan deal could violate World Trade Organization rules that require international agreements to cover “substantially all” trade. However, Washington and Tokyo have framed the document as one step in an ongoing process. The Office of the USTR has stated that “The United States looks forward to further negotiations with Japan for a comprehensive agreement that addresses the remaining tariff and non-tariff barriers and achieves, fairer, more balanced trade.”

For the Trump Administration, the deal compensates for access to the Japanese market lost when the U.S. pulled out of the Trans-Pacific Partnership (TPP). The withdrawal advantaged third-party competitors like Canada, New Zealand and Australia that chose to remain within the now
11-member trade pact. However, the new bilateral deal is less comprehensive; even the agricultural provisions fall short of what TPP delivered to U.S. exporters in some cases, including for goods like rice and some dairy products. Both the primary agreement and the side agreement on digital trade came into effect on January 1, 2020. Second round negotiations over the coming year could further shape the economic relationship between the world’s first and third-largest economies.

**Japan – South Korea Dispute**

In the fall of 2018, the supreme court of South Korea ordered two Japanese companies, Mitsubishi Heavy Industries and Nippon Steel, to pay compensation to Korean plaintiffs subjected to forced labour during the period of Japanese colonial rule. Nachi-Fujikoshi faced an equivalent decision at the appellate level. The Government of Japan disavowed the judgements, arguing that it had already paid restitution in a past reparations agreement: the 1965 Treaty on Basic Relations provided for hundreds of millions in Japanese loans and grants. In July 2019, Tokyo imposed new controls on three materials critical to the Korean technology sector, including fluorinated polyimide, photoresists and hydrogen fluoride. The new regulations require Japanese exporters to obtain special licenses, effectively constituting an added barrier to trade. Although the Japanese government characterizes the new measures as an unrelated procedural reform, outside analysts have interpreted them as a response to the South Korean court rulings. In August, Japan took an additional step by removing South Korea from its preferred trade partners or “White List,” adding new checks on goods trade to avert potential military applications.

South Korea has responded in-kind to Japan’s actions. The governing Democratic Party labelled the White List exclusion an act of economic war. Seoul proceeded to remove Japan from its own list of preferred trade partners in September, although it similarly denied that the move was retaliatory. Popular boycotts of Japanese goods have had acute effects on consumer brands like Toyota, Nissan and Asahi, while Mitsubishi, Nippon Steel and Nachi-Fujikoshi have had assets in South Korea seized. Furthermore, Seoul announced that it would pull out of the bilateral General Security of Military Information Agreement (GSOMIA) in August, an accord that facilitates intelligence sharing with Japan concerning the North Korean military and nuclear weapons program (a decision later reversed in November).

In terms of macroeconomic risk, the Japanese – South Korean dispute imposes new costs on the global technology supply chain in which both countries are critical players. Leading Korean tech companies Samsung and SK Hynix have acknowledged the challenges presented by the new Japanese trade measures. In recent months, however, there have been some initial moves toward reconciliation. In mid-December, trade officials from both countries met for talks in Tokyo. The two parties acknowledged some progress and voiced their willingness to return to the negotiating table at a future date. Japan even took steps to ease its technology exports controls on December 20th, prior to a trilateral summit on December 24th in Chengdu, China, where Prime Minister Shinzo Abe and South Korean President Moon Jae-In engaged in direct discussions. Nevertheless, Japanese PM Abe reportedly views the tensions as a long-term problem, expected to last years. It remains to be seen whether the existing momentum will yield lasting results in 2020.

**World Trade Organization (WTO) & the Appellate Body**

The World Trade Organization (WTO) is the principal international body tasked with overseeing goods and services exchange between states. Created in 1995, it serves as the successor to the General Agreement on Tariffs and Trade (GATT) and comprises 164 member countries. The WTO supports a more open and nondiscriminatory trading system, not only helping to lower barriers to exchange but mediating disagreements that could otherwise morph into trade wars. When WTO members clash over trade practices and cannot arrive at a resolution through negotiations, their case can be heard before the dispute settlement panel. If the parties disagree with the panel’s ruling, they can further appeal to the appellate body: an impartial, standing court whose judges serve for set terms. With seven appointees at full strength, the appellate body must have at least three
members at any one time in order to function. Under the Trump Administration, however, the United States has deliberately blocked the appointment process for appellate judges. With grievances dating back to previous administrations, the U.S. essentially accuses the WTO of overstepping its mandate, broadly interpreting existing rules to the point of making new law and depriving the rights of or assigning new obligations to member states.\textsuperscript{49}

In recent months, U.S. obstruction has inflicted debilitating damage to the appeals system. As of December 10th, 2019, the terms of service expired for two of the three remaining appellate judges, leaving the panel short of the minimum threshold required for operation. Although the dispute settlement panel can still hear cases, both plaintiffs and defendants can effectively freeze them indefinitely through appeal. In the interim, a sub-group of members, including the European Union, have taken steps to create a supplementary court that can manage dispute resolution until the appellate body can function properly, but it is unclear what critical mass of support this initiative can garner.\textsuperscript{50}

Paralysis at the WTO is a notable macroeconomic risk in 2020 because trade disputes can metastasize into severe market disruptions without an institutional outlet for fair mediation and resolution. States can engage in restrictive or discriminatory practices without fear of sanction from the WTO.\textsuperscript{51} With the appellate body in limbo, unilateral trade actions of the kind taken by the Trump Administration could grow more common and widespread.\textsuperscript{52}

CONCLUSIONS

Looking forward, the course of international trade paints a mixed picture for Canadian financial services. Closest to home, the successful ratification of the USMCA provides important assurances for goods and service providers that key North American import/export markets will remain open, albeit subject to revised but clear rules and standards. Avoiding major economic dislocations, like in the Ontario automotive industry, reduces the downstream credit and market risks to institutional lenders and investors. The U.S.-China Phase 1 deal helps to ease global volatility, yet multi-sectoral tariffs continue to impose added costs on supply chains and unresolved U.S. grievances could lead to renewed escalation. The enduring tensions between Japan and South Korea, and the staged resolution between Japan and the U.S., increase both uncertainty and confidence in three critical economies. And at the WTO, paralysis in the appellate body could allow bilateral disputes to escalate into sustained trade barriers and discriminatory practices, without standard procedural remedies. This deeper structural threat to the global trading system is abstract in form with a longer time horizon. Yet if it signals chronic decay in multilateral rule-setting for trade, shifting the macroeconomic paradigm to which Canadian financial institutions are accustomed, it will present more acute challenges in both domestic and foreign markets.