



Unravelling the U.S. – China Trade Dispute

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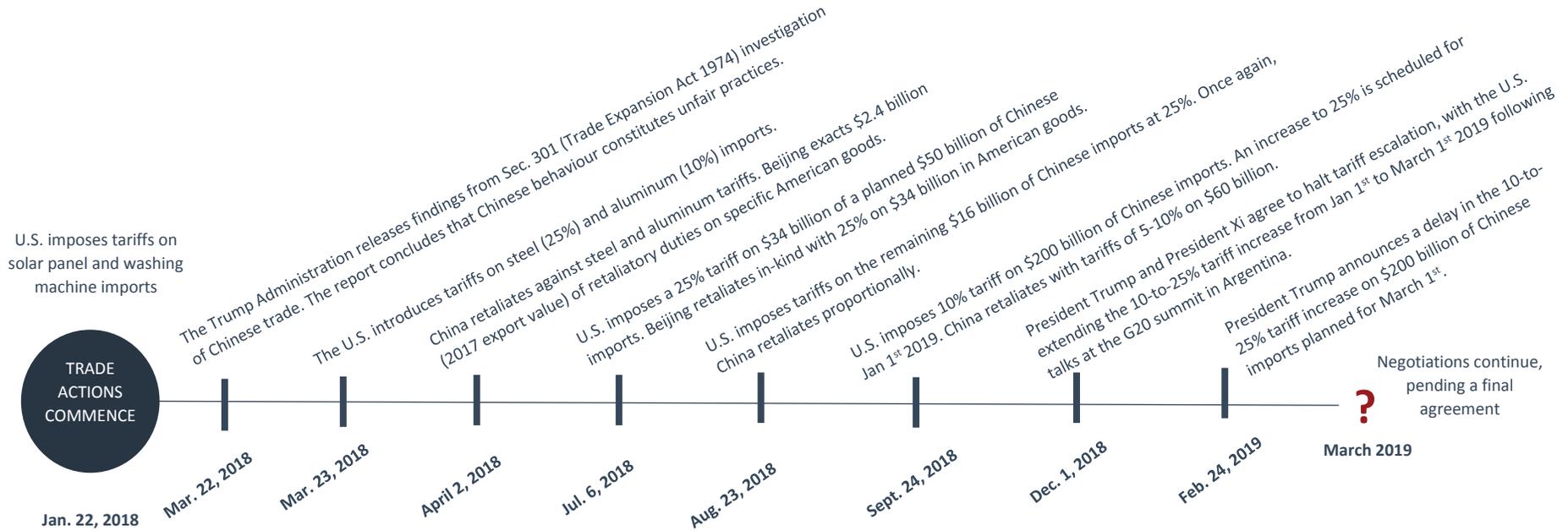
Introduction

Having advocated a hard line on China in the 2016 election, President Donald J. Trump has directed a trade campaign designed to pressure Beijing to increase its imports from the United States and implement structural reforms. His strategy thus far rejects the course taken by Washington for nearly 50 years. Since Richard Nixon first opened relations with the People’s Republic in the early 1970s, the U.S. has operated on the assumption that greater political, economic, and cultural interconnections would help to shape Chinese policy in line with American preferences.¹ U.S. efforts to build a positive bilateral economic relationship included the decision to support Chinese admittance to the World Trade Organization (WTO) in 2001,² a milestone that spoke to Beijing’s own appetite for market liberalization.³ However, China’s political and economic behaviour upon its accession to the WTO did not change to the extent that Washington expected. China failed to democratize or fully open its market to foreign participation,⁴ and many of the promised benefits to the American economy did not materialize.⁵ For some time, U.S. businesses and policymakers tolerated discriminatory economic

practices because they deemed market access in China too lucrative to abandon, and pushed for incremental rather than large-scale changes to the incumbent system. Attitudes have since shifted as once tolerable barriers-to-entry are framed in more critical terms.⁶ In this context, the ongoing trade dispute reflects an effort to recoup the promised, but as of yet undelivered, benefits that first animated U.S. support for China’s incorporation into the global trade system.⁷

For the Canadian financial services industry, the trade war presents complex and ambiguous risks. Punitive tariffs and general market uncertainty induce volatility, disrupt supply chains, and disincentivize new investment in the short-term. The dispute also creates a more protracted challenge in that it holds the potential to shape the future political relationship between the U.S. and China and thus the global economic system over the long-term. In anticipation of a concrete agreement, financial institutions should understand the context of the trade tensions, and begin to grapple with the interests and objectives of the two parties. This information can help risk managers to map out the probable terms of a deal, should one emerge.

Timeline



U.S. – China Trade Dispute 2018/19

Source: Brown and Kolb, *Peterson Institute for International Economics*

The U.S. – China trade dispute has included both instigating and retaliatory actions, some of which target specific products while others apply broadly across exporting sectors. One of the Trump Administration’s earliest maneuvers followed a report published by the U.S. International Trade Commission (ITC) in the autumn of 2017, concluding that imported solar panels and washing machines harmed domestic producers.⁹ The White House imposed tariffs on these two goods in January 2018,¹⁰ with China among the most affected

countries.¹¹ A second wave of U.S. tariffs followed a Department of Commerce report on steel and aluminum imports, released in mid-February. On March 23rd, levies of 25% on steel and 10% on aluminum were imposed on a list of foreign exporters; eliciting retaliatory duties from Beijing of near equal value.¹² The action most consequential to the ongoing negotiations, however, followed the conclusion of the investigation launched by the United States Trade Representative (USTR) under Section 301 of the Trade Act of 1974, which ruled that

Chinese economic practices unduly discriminate against American business. Over the summer of 2018, the Administration planned and launched tariffs of 25% on \$50 billion and 10% on \$200 billion worth of Chinese imports. This action garnered yet another largely proportional response from Beijing, and President Trump announced an increase in the 10% rate to 25%, set for January 1st.¹³ Trump and Chinese President Xi Jinping eventually agreed to a 90-day ceasefire in the escalating conflict at the November 2018 G20 summit in Argentina,¹⁴ and in late February, the U.S. president postponed the 10-to-25% tariff increase once again, referring to the “substantial progress” made in the negotiations.¹⁵

Potential Economic Effects

China and the U.S. maintain a considerable trade relationship, with almost \$660 billion worth of total goods exchanged (imports + exports) in 2018.¹⁶ The trade dispute has thus far inflicted some discernable costs on the two economies. In Q3 of 2018, Chinese growth sank to its lowest rate since 2009; a drop at least partially attributed to the tariff barriers raised by and against Washington. Furthermore, researchers estimate that the tariffs exacted an additional \$3 billion per month in tax costs on U.S. importers and consumers by year’s end 2018, and a \$1.4 billion per-month deadweight welfare loss.¹⁷ Certain sectors have incurred greater losses than others: From January through October of 2018, the Department of Agriculture reported a 42% drop in agri-export shipments to China.¹⁸ If the Trump Administration followed through on its threat to increase the duty on \$200 billion of Chinese imports from 10-25%, the United Nations Conference on Trade and Development forecast a \$160 billion decrease in exports from the Asian region, with supply chain disruptions.¹⁹

Legal Context

The Trump Administration has leveraged statutory law to unilaterally enforce punitive tariffs against China and/or other nations. The laws invoked delegate certain congressional powers to the executive branch, creating exceptions to the constitutional division of powers that license the president to remedy specific trade-related threats to U.S. commerce or national security. With respect to the current negotiations between Washington and Beijing, the following terms provide some vital context:

The U.S. Constitution, Articles I & II

Article I, Section 8 grants Congress authority over taxation, duties, excises and imposts, in addition to the explicit right “To regulate Commerce with foreign Nations”;²⁰ a provision typically interpreted to include trade policy.²¹ However, congressional authority over international trade runs up against the President’s right to conduct foreign relations as set forth in Article II.²² Creating a streamlined legal process while still respecting constitutional prescriptions, Congress first devised a supplementary mechanism called Trade Promotion Authority (TPA) or “Fast Track” in 1974. This procedure empowers the executive branch to negotiate trade agreements, with the approval of and in consultation with Congress, and requires only simple majorities ($\geq 50\%$) in the House and Senate for ratification (legislative amendments are prohibited).²³ It is under the TPA that the Trump Administration recently negotiated the United States-Mexico-Canada Agreement (USMCA).

Section 301 of the Trade Act of 1974

Under this provision, the USTR is granted the discretion to evaluate U.S. trade relationships and assess whether another country is denying U.S. rights or benefits under any trade agreement, or whether that foreign party is violating or acting inconsistent with said agreement. The USTR can also judge whether an action or policy “is unjustifiable and burdens or restricts United States commerce.”²⁴ If a country is failing to meet its obligations as defined under 301, the USTR may then take retributive action, subject to the President’s discretion, that is intended to eliminate the discriminatory trade policy, law or practice and/or properly safeguard U.S. rights and interests. Acceptable tools include tariffs or binding agreements with the offending nation, requiring it to reform or provide compensation.²⁵ With respect to the investigations launched against China under Section 301, the current USTR, Robert Lighthizer, has specified that the Administration is only seeking an “executive agreement” with Beijing as is permitted under Section 301, and so will not need congressional approval as is otherwise mandated by TPA.²⁶

Primer for the Talks: The Results of the 301 Investigation

The Section 301 report compiled by the Office of the USTR determined that “China’s acts, policies, and practices are unreasonable and discriminatory, and burden or restrict U.S. commerce.”²⁷ The report details four overarching American grievances:

a) Technology Transfer Regime

U.S. companies are obliged to form joint ventures with Chinese companies in order to enter the market, and are effectively

required to transfer sensitive technologies to facilitate these partnerships.²⁸ However, the transfer rules deny American firms their intellectual property to the benefit of potential Chinese competitors.²⁹

b) Discriminatory Licensing Restrictions

Chinese laws around technology licensing prevent American companies from securing market-based prices for their technologies, and create pressure for additional IP transfers in exchange for necessary administrative approvals.³⁰ These restrictions place additional burdens on U.S. IP holders, and limit the value they can recover from their technologies.³¹

c) Outbound Investment Strategy

With the goal of making China a technological leader worldwide, the state helps domestic companies to secure foreign technologies through predatory investment in and acquisition of U.S. firms. State-owned enterprises (SOEs) are often responsible for these activities, capitalized by state-funded banks, giving them a distinct advantage in credit access otherwise unavailable in the free market. Meanwhile, U.S. companies face significant restrictions when investing in China.³² The result makes American companies less competitive, stifles American innovation, and causes price distortions with respect to investment in IP intensive industries (with state support, Chinese companies can essentially afford to overpay for technology assets, which inflates prices).³³

d) Cyber Intrusions and Theft

The Chinese government has conducted or supported cyber espionage of U.S. companies in order to steal valuable commercial information that serves its economic objectives.³⁴ Sectors with strategic significance to China are frequently the targets for

hacking. American companies are not only harmed by the compromise of sensitive information, but can face remediation, reputational and other costs in the wake of a cyber intrusion.³⁵

USTR Lighthizer has specified that the negotiations underway fall largely within the confines of Section 301, and so do not pertain to contested issues beyond the scope of the report or the legal powers granted by the statute.³⁶

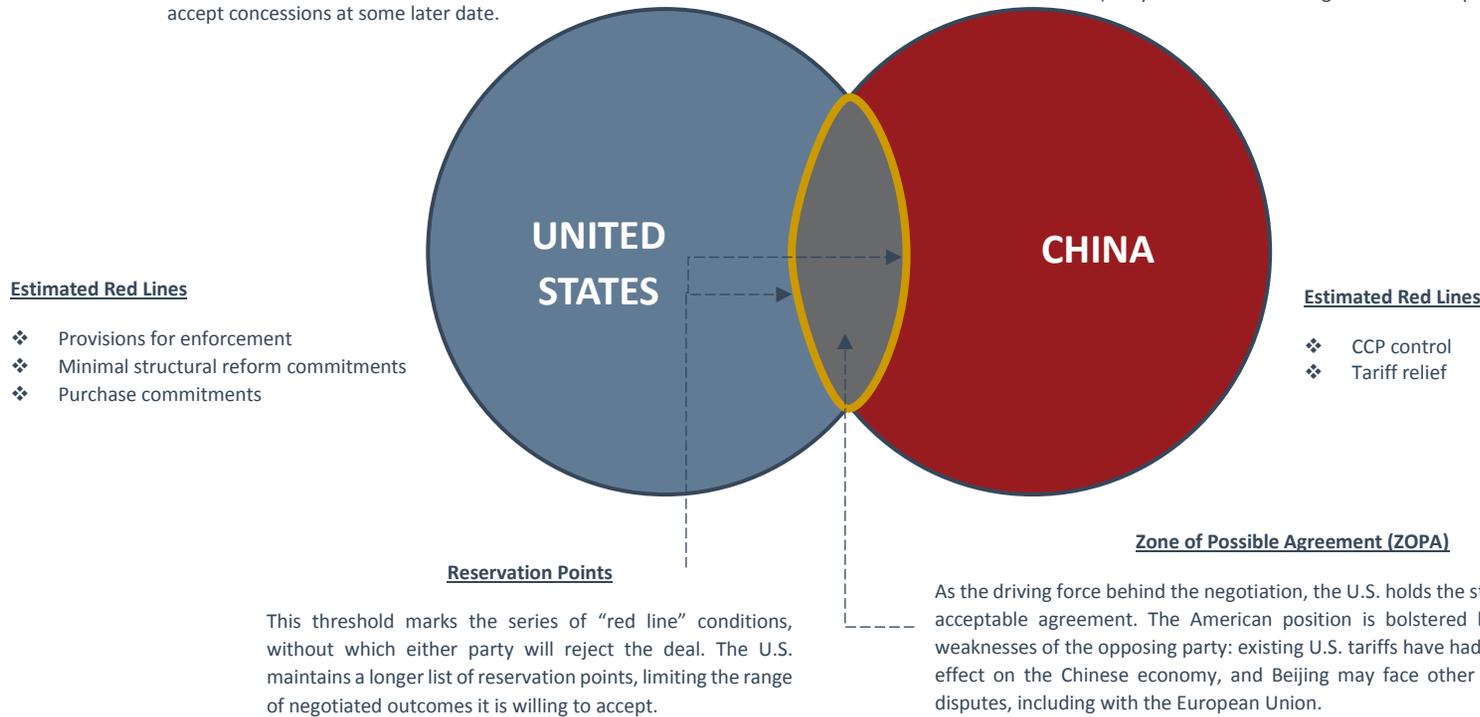
Mapping the Negotiation

BEST ALTERNATIVE TO A NEGOTIATED AGREEMENT (BATNA)

For the Trump Administration, the preferable substitute to a deal would be the status quo, whereby the U.S. maintains or even strengthens its tariff regime against Chinese goods, probably with the hope that the building economic costs will push Beijing to accept concessions at some later date.

BEST ALTERNATIVE TO A NEGOTIATED AGREEMENT (BATNA)

Absent an agreement, China could prefer to hold steadfast in rejecting American demands while hoping the U.S. repeals its tariffs without concessions (likely due to the mounting economic and political costs at home).



The American Position:

The U.S. occupies a position of relative strength in the negotiation, and is seeking clear and deep commitments from Beijing. Although the trade barriers raised in the past year could inflict some harm on the American economy, they are poised to have a more detrimental impact on China.³⁷ This discrepancy may bolster Lighthizer's bargaining power, in that the economic costs of the dispute could push Beijing to make greater concessions in exchange for some tariff relief. In the event that the talks break down, the U.S. Best Alternative to a Negotiated Agreement (BATNA) is probably the status quo, by which the import duties are sustained or even raised against Chinese products, with the hope that the mounting pressure forces Beijing back to the table. In any event, the U.S. is mindful of contingency: Lighthizer has stressed that the parties may not reach a consensus after all, and that any successful deal would still be part of a larger effort to monitor and address Chinese trade practices over the long-term.³⁸

With respect to its other advantages, the White House has some leeway given its strong position in the Two-Level Game. This concept postulates that the executive branch of government actually engages with two different entities in any international negotiation: the party across the table and the various domestic constituencies with a stake in the outcome. An agreement must satisfy both the negotiator's objectives and those of other government institutions, non-governmental actors, or other interests at home.³⁹ Given that Congress' endorsement is not legally required to ratify a deal with China under Section 301, the White House does not need to account for diverging interests on Capitol Hill in the same way it might with a conventional free trade agreement. Lighthizer has expressed his

willingness to consult and hear the specific concerns of members in the House and Senate.⁴⁰ However, the largely bipartisan consensus in favour of a robust approach to Beijing,⁴¹ notwithstanding some divergence over tactics,⁴² decreases the probability that the Administration will face significant opposition from congressional Democrats or Republicans in the remaining stages of the bargaining process.

Statements from USTR Lighthizer in congressional testimony suggest that the U.S. will seek a commitment from the Chinese to purchase more American agricultural and other goods;⁴³ given that it serves to address the trade imbalance that President Trump has prioritized throughout his term in office, it may be treated as a red line. Two other critical "walk-away" issues could be minimum structural reform, including changes to tech transfer requirements and IP protections, and most critically, an enforcement mechanism that provides for punitive measures in the case of non-compliance.⁴⁴ The U.S. negotiators will probably want the enforcement provisions to allow for a tariff snapback without a right to Chinese retaliation, and are likely to seek a delay in the repeal of existing tariffs until Beijing starts to move on its obligations (should an agreement be reached).⁴⁵

The Chinese Position:

With the impact of the existing tariffs, the recent slowdown in the Chinese economy⁴⁶ and its greater dependence on trade,⁴⁷ and the risk of confrontations with other markets like the European Union,⁴⁸ Beijing's standing vis-à-vis the U.S. does seem comparatively weaker. However, it is possible that the one-party system of governance may help the Chinese Communist Party (CCP) respond more effectively to trade disruptions and outlast Washington in a prolonged standoff. In terms of the Two-Level game, the nature of the Chinese political

system could help to mitigate any coordination problems that might otherwise challenge trade negotiators, even as Beijing aims to satisfy its domestic constituencies to the utmost extent possible. Thus, the Chinese BATNA may reflect the status quo, but is predicated on the belief that a firm stance against the Trump Administration will eventually instigate some form of U.S. retrenchment without the need for significant concessions.

Since import duties serve as the primary source of American leverage, China will probably hold some commitment to tariff relief as a red line issue in a successful agreement. Perhaps the most significant reservation point, upon which the negotiation may hinge, is the preservation of Communist Party control over the Chinese economy. Elizabeth Economy, Director for Asia Studies at the Council on Foreign Relations, describes how Xi Jinping has ushered in a “Third Revolution” in China; the central goal of which is the great rejuvenation of the Chinese nation. His core strategy includes both the mass centralization of power and the reassertion of the CCP in the political and economic spheres. Beijing has pushed for increased protectionism and capital flow restrictions, along with direct Party influence over private companies.⁴⁹ As argued by William Alan Reinsch

of the Center for Strategic and International Studies, Xi’s policy objectives run contrary to the current U.S. demands for structural reform.⁵⁰ The disparity between these preferences significantly reduces the Zone of Possible Agreement (ZOPA), and thus the prospects for a successful deal.

Conclusion

As the bilateral negotiations proceed and new information arises, iterative probing of the objectives and bargaining positions of the U.S. and China can help to inform scenario analyses and risk management practices. The final outcome remains uncertain, however, and even if an agreement does materialize, it may only represent one phase of a larger contest between two superpowers that spans multiple domains and holds far-reaching geopolitical and economic consequences. Financial institutions should recognize that the strategic competition between the U.S. and China does not just pose a short-term risk, and that it could create divergent rules and standards over decades, to which international firms must be ready to adapt. Beware: there could be more storms ahead.

Endnotes

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