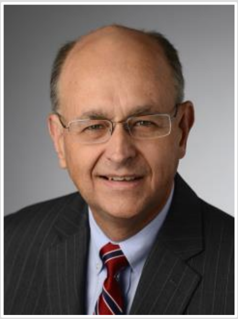

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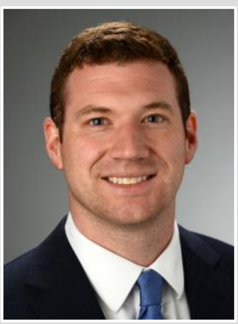

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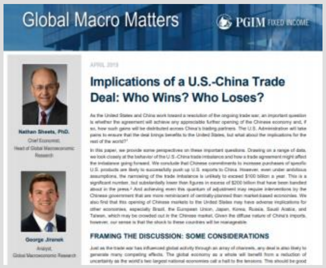

Global Macro Matters

Implications of a U.S.-China Trade Deal: Who Wins? Who Loses?

Published in April 2019

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January 2020

The Implications of the U.S.-China Trade Deal Revisited

The completion of the Phase 1 agreement marks a cease fire in the U.S.-China trade war, and the deal underscores several persistent issues that we considered in a white paper published in April 2019.

The details of the deal have been discussed elsewhere but, in brief, both sides have made some moderate concessions. The United States is canceling planned tariff hikes and, to a limited extent, rolling back existing tariffs. In addition, the U.S. Treasury has reversed its "currency manipulator" finding imposed on China last summer. The Chinese in turn have promised to take some measured steps to increase protections on intellectual property, further open their financial sector to foreign ownership, manage their currency in a transparent way, and increase their purchases of U.S. goods by $77 billion in 2020 and $123 billion in 2021 (relative to 2017 levels).[1]

China's commitment to meaningfully hike imports from the United States strikes us as the pivotal element of the deal, at least in terms of determining its longevity. If the U.S. Administration views China's future actions as a good faith effort to follow through on the deal, President Trump may be less inclined to re-escalate his rhetoric and scupper the agreement. For now, President Trump's re-election bid benefits from heralding the large dollar figures included in the deal.

The agreement raises a series of questions about the feasibility of these commitments: Can China possibly raise its purchases as promised? If so, how can this be done and what are the broader effects of such commitments on the global economy—who wins and who loses?

We considered exactly these issues in our prior research, and the perspective in this paper draws heavily on that work. We find that China's commitments to hike imports from the United States range from those that will be challenging (manufacturing and services) to those that will likely be even more difficult (agriculture and energy). These concerns notwithstanding, we believe the agreement greatly reduces the probability of an escalating trade war during the year ahead, which should be positive for economic confidence and the markets.

Assessing the Purchase Commitments—Are They Reasonable?

Our earlier paper delved into the potential magnitude of China's additional purchases from the U.S. Our general findings, along with the commitments in the recent deal, are shown in the following table (Figure 1). Several observations jump out.

[1] *Combined, the commitments for these two years yield the headline number of $200 billion in increased purchases.*

First, the size of the commitments is large relative to existing trade flows. For example, the Chinese have committed to increase their purchases of U.S. energy by $34 billion by 2021, versus baseline purchases of just $7 billion. Similarly, agricultural imports will rise by $20 billion, nearly doubling current imports of $24 billion. In total, China's imports of these products are seen to rise by $123 billion by 2021, an 80% increase.

Figure 1: The Phase 1 Deal (billions USD)

	China's Imports from the U.S. Actual	China's Imports from the U.S. Agreed Increase*		China's Imports from World Actual	U.S. Exports to World Actual	China's Imports from the U.S. Our Estimate of Feasible Increase*
	2017	**2020**	**2021**	**2017**	**2017**	**2024**
Manufacturing	78	33	45	872	758	61**
Agriculture	24	13	20	123	150	12
Energy	7	19	34	214	84	20
Services	40	13	25	287	337	--
Total of Above	**150**	**77**	**123**	**1,496**	**1,328**	**--**
Total (ex. Services)	*109*	*64*	*98*	*1,209*	*991*	*93*

**Relative to 2017 baseline. **Sum of estimated adjustment in Autos, Aircraft, and Electronics.*
Source: UN Comtrade Database, BEA (for services), U.S. Treasury, and China's State Administration of Foreign Exchange.

Second, the size of the deal's commitments mirrors the findings of our prior research in some important ways. The most striking similarity is that we found scope for total adjustment across manufacturing, agriculture, and energy of $93 billion, while the corresponding figure in the trade deal is $98 billion. That said, we were envisioning the agreement would ramp-up through 2024, and we saw such levels as the upper bound of what might be possible. The current trade deal reaches broadly similar aggregate levels much more rapidly. Further, our estimates for potential adjustment in agriculture and energy were very similar to the first-year commitments in these categories (within $1 billion). The trade deal, however, sees significant further increases in 2021. Finally, our manufacturing numbers were somewhat above those in the agreement. We leaned aggressively into the possibilities for semiconductors, given stories in the press at the time indicating that figures over $100 billion were being considered.

Third, our paper did not consider services because it seemed that the Administration had little interest in bringing services into the negotiations. However, as we noted in the paper's conclusion:

> *[I]t is surprising that the U.S. Administration is apparently not prioritizing a further opening of China's services market. The United States has comparative advantage in services and runs a surplus with China. The Administration has instead focused mainly on goods. But, clearly, enhanced access for U.S. firms providing information technology services, consulting, entertainment, advertising, and financial services would provide a meaningful lift to overall exports.*

As such, the inclusion of services in the trade agreement is constructive, and we see scope for meaningful traction in this category. Further, progress on services trade will be facilitated by China's contemplated steps toward enhanced intellectual property rights, although there is still be much work to be done in this area.

This discussion brings us to a bottom-line question—are the agreed targets achievable? Looking across categories, we're most optimistic about manufacturing and services. These are large categories; the United States has significant supply capacity, and China should have ample demand. While the proposed increases will be challenging, meaningful progress in these two categories seems possible. In contrast, the commitments appear more difficult for agriculture and energy over a period of just two years.

Notably, in announcing the deal, President Trump alluded to these issues. For example, to meet the agriculture targets, he said that U.S. farmers would need to "go out and get bigger tractors." This highlights an underlying time-consistency problem inherent in the agreement. The ambitious nature of the announced targets has benefitted President Trump politically. The flip side is that China may struggle to achieve them. This suggests that the deal is likely to become increasingly tenuous as time passes, particularly in 2021.

Some Broader Thoughts

Several other, more general thoughts warrant consideration. First, purchases of the envisioned size probably won't arise organically in the Chinese economy. Rather, China's state-owned enterprises, or the government itself, will most likely need to make many of the envisioned purchases. And this may imply significant stockpiling, rather than a sustainable increase in demand for U.S. products. As such, this structure of the agreement strikes us as more resemblant of central planning—with the government setting targets and using its instruments to achieve them—than of the market-based reforms that the United States has typically encouraged. While increased purchases will no doubt be welcomed by U.S. exporters, the implied backtracking on reform momentum may over time have adverse consequences for China and the global economy.

As a related point, even if the targets are somehow achieved, it is unlikely that China's overall imports will be $200 billion higher than they would have been otherwise. In other words, the increase in expenditures on U.S. goods is likely to bring reduced purchases of goods from other countries. The data suggest that the losers are likely to be Brazil in agriculture; Australia, Russia, Saudi Arabia, and Angola in energy; a range of Asian countries in tech and electronics; and, perhaps, the European Union in autos. Our sense is that the purchases of U.S. services are the most likely to comprise a net addition to China's imports. U.S. services providers—if given an opportunity to compete on a more level playing field—should be capable of offering products that are not currently available in the Chinese market.

Another question is the extent to which China's increased U.S. purchases will actually lift overall sales of U.S. products. For example, if U.S. soybean producers mainly redirect their products from other markets to China, countries like Brazil are likely to correspondingly redirect their products from China to these other markets. The result would be an inefficient reshuffling of trade relationships, with little net effect on each country's overall production. This highlights the value of multilateral, or at least broad-based, approaches to trade liberalization. As numerous countries simultaneously tear down trade barriers, this creates new opportunities for trade to occur globally, rather than just diverting existing production from one destination to another.

Finally, a proximate question is how the trade deal affects the macro outlook? We believe that both President Trump and President Xi have incentives to work within the context of the agreement, at least through the coming year. For President Trump, it is a concrete achievement that he can point to during the election year—and a re-escalation of the trade war could create unwelcome disruptions to the economy and markets during the campaign. For President Xi, his plate is already full managing China's economic slowdown, financial de-risking, and the situation in Hong Kong. Putting the trade war with the United States on the back burner, even temporarily, makes managing these other priorities more feasible.

As such, we view the trade deal as sharply reducing the probability that trade tensions between the United States and China escalate during the coming year, thus, removing a prominent downside risk. We see this as limiting uncertainties for the markets and supporting risk taking in the year ahead. What the deal doesn't do is resolve the longer-term tensions in the U.S.-China relationship, including the possibility that Trump might re-stoke the trade war during a potential second term, especially if China has fallen short on its purchase commitments. For this reason, we are doubtful that the deal will prove sufficient to support a meaningful increase in confidence in the corporate sector and an upswing in investment. In addition, there is still much work to be done on many of the deep structural issues in China's economy—intellectual property rights, technology transfer, state-owned enterprises, and openness to foreign competition—some of the original objectives of the trade war.

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2020-0499

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PGIMJ202001240073