What Comes after the U.S.-China Phase One Trade Deal?

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What should the United States do next about the trade and broader economic challenge posed by China? This question, which was raised in January as soon as the two governments signed a deal tantalizingly called "phase one," has seemed especially difficult to answer since President Trump declared on July 14 that he wasn't interested in proceeding with phase two negotiations. Indeed, political and economic uncertainties regarding China abound. What will the United States do next about China if Democratic nominee Joe Biden wins the presidency? Alternatively, what will President Trump do if he's reelected? And what will the president do between now and the election?

Biden skeptics are wondering how the former vice president could contain the bipartisan hostility toward China that has surged in Washington and around the country in recent years—if he even wants to. In the meantime, Biden's existing China record is dominated by the standard pre-2016 hope of transforming the People's Republic into a "responsible stakeholder" in the world community.

Trump skeptics, meanwhile, are asking whether the president is so invested in preserving the trade deal—especially China's promises to boost agricultural imports from politically important states—that he will overlook major Chinese violations. Many also suspect that former national security

adviser John Bolton, author of a recent kiss-and-tell book, is right in warning that the president could drop the tough-on-China stance altogether as soon as he's reelected. Political speculations aside, however, the results of phase one are sending a loud and clear message: Washington should stay the course.

The Success of Phase One

America simply doesn't need to enter phase two of a China deal, as phase one has been skillfully negotiated and heavily favors the United States. In fact, seeking a follow-on deal is likely to distract American policymakers from pursuing the essential goals that phase one has put well within reach: revitalizing America's domestic industry and minimizing the influence of an increasingly hostile China on America's own security, prosperity, and political system. This strategy, however, should also be supported by maintaining the tariffs that have been imposed on hundreds of billions of dollars of Chinese exports to the United States. Phase one allows nearly all of these levies to remain in place—a clear-cut victory for the United States.

Analyses of the phase one deal have focused on two of its main features. The first entails pledges made by China to boost, within two years, its imports from the United States in numerous categories of goods and services by some $200 billion over their 2017 levels. The second entails various commitments from Beijing to end or reduce a wide variety of predatory trade practices, like deliberate currency undervaluation (which artificially makes goods from China more price-competitive in markets all over the world), intellectual property theft, forced technology transfer from U.S. companies in exchange for access to China's market, and various supposed

health and safety regulations that American exporters claim are mainly designed to keep their products from being sold to Chinese customers.

The import pledges are especially important because they represent a long overdue departure from the kinds of purist maxims that have decisively and regrettably shaped American trade policy. The Trump administration has concluded, at least in this respect, that boosting American sales to a systematically restricted national economy must not depend on extracting promises to end or reduce individual trade barriers. Such impediments are eminently fungible, and the bureaucracies that create and maintain them are too opaque to permit effective monitoring and enforcement. Instead, the approach developed by U.S. Trade Representative Robert E. Lighthizer seeks measurable results. This strategy, often called "managed trade," simply requires the Chinese to hit targets for purchases that are easily tracked by payments into exporters' coffers.

Moreover, contrary to claims that the promised increases are dominated by politically important agricultural products, these goods make up only 16 percent ($32 billion) of the $200 billion—and of that $32 billion, only $12.5 billion must be bought by the end of this election year. The remaining two-year quotas are made up of manufactures ($77.7 billion in total), energy goods ($52.4 billion), and services ($37.9 billion).

China's promises of greater market opening and other improved economic behaviors are much less specific—a supposed weakness in the accord that has drawn the ire of critics. After all, they have argued, in previous years these transgressions are what harmed so many American workers and businesses trying to compete with Chinese firms—in the United States, in

China, and in third-country markets. Moreover, they correctly observe, the combination of subsidies, intellectual property theft, technology transfer pressures, and discriminatory government procurement practices known as Made in China 2025 are precisely the measures that have so alarmed the Trump administration. Those measures have helped China close the remaining technology and military power gaps with the United States, and threaten to further augment China's strength and wealth at America's expense. Without ironclad phrasing (and therefore presumably airtight enforcement), the critics continue, these treaty provisions are worthless because of China's poor record of complying with any such agreements.

The critics are right about the importance of combating these Chinese practices. Their dissatisfaction with the treaty's wording, however, misses the point and overlooks the seminal importance of the dispute resolution system created by phase one. If used boldly and shrewdly, the mechanism to which China agreed creates all the leverage Washington needs to bring China to heel. The agreement accomplished this aim because, unlike any of its predecessors, the Trump team acted as if economic reality mattered—recognizing that the United States still holds the important economic cards in its dealings with China.

As with most U.S. trade agreements, phase one's dispute resolution section lays out detailed procedures for addressing complaints that either signatory can lodge against the other. And as with most U.S. trade agreements, these procedures include various time frames for requesting and receiving information, holding consultations, reporting progress, and the like.

The game-changing difference between phase one's dispute resolution system and that of its predecessors lies in what happens if, after all the proper procedures are followed, one of the signatories is still dissatisfied. In the two most important U.S. trade deals of recent decades, the North American Free Trade Agreement (nafta) and the terms of U.S. entry into the World Trade Organization (WTO), the decisive provisions created procedures that eventually disadvantaged the United States. In the case of nafta, the main problem was the preservation of an arrangement dating from the 1987 bilateral trade deal between Canada and the United States that gave each of the signatories of the new agreement (now including Mexico) the same legal authority to defend industry subsidies, even though the U.S. economy represented some 82.5 percent of the new free trade area at its inception. (That arrangement had been an especially high priority for Canada, a robust commodity subsidizer.) Since access to the U.S. market was the paramount nafta prize, both Mexico and Canada pressed for keeping this "Chapter 19" system, to ensure that America's market would remain more open to their exports than vice versa. (The Trump administration's United States-Mexico-Canada Agreement left the Chapter 19 procedures in place, in exchange for Canadian and Mexican concessions on other dispute-resolution issues such as labor and environmental protections and tariffs imposed for national security purposes.)

The WTO system featured an even greater disparity between legal authority and American power. Despite being the world's largest single national economy by far and long serving as the world's leading import sponge, the United States in WTO proceedings and disputes has no greater voice or vote than any of the 163 other members of the organization, no matter how Lilliputian their economies. And because unfettered access to the U.S.

market was a main growth engine for so many WTO members, the latest available figures show that the United States has lost more than half the WTO cases it has been involved in over the years—although it still runs nearly half of the globe's total trade deficits even after transforming into an oil exporter. Just as important, the WTO has conspicuously failed to rein in foreign predatory trade practices that keep other markets closed to U.S. products—notably in China.

The odds of phase one improving on this sorry record seemed slim throughout the negotiations. China insisted that any enforcement provisions treat the two countries as legal equals—thereby ensuring its ability to brush off any complaints filed by the United States. And the Trump administration repeatedly expressed agreement.

Yet Lighthizer evidently realized that he had the biggest ace up his sleeve all along—the supreme importance of exports (and thus trade surpluses with the United States) to China's development, and China's comparatively lower importance—despite all the decades of hype—to the United States. Precisely because of superior American leverage, Trump's trade envoy secured Beijing's agreement to an enforcement mechanism that provided China with de jure equality. But de facto the agreement gave Washington the last word.

Phase one doesn't enable a defendant (as China, the more closed and protectionist of the signatories, is likely to be) to use a veto to escape any consequences for treaty violations. And it doesn't authorize China to respond with tit-for-tat, politically adroit tariffs (as with its recent levies on soybeans) if the United States—the likely plaintiff—loses patience and imposes its own unilateral trade curbs.

As phase one's text specifies, a "Party Complained Against [for an alleged treaty violation] may not adopt a counter-response, or otherwise challenge such action. If the Party Complained Against considers that the action of the Complaining Party was taken in bad faith, the remedy is to withdraw from this Agreement by providing written notice of withdrawal to the Complaining Party." Although both the United States and China enjoy an equal right to walk out, such a threat would have little credibility due to China's dependence on maintaining access to as many American customers as possible. Even if China walked out, however, the damage to the United States would be manageable compared to the hefty price that China would have to pay. This argument is borne out by the data from the period before phase one, when the "trade war" was at its most intense.

In fact, phase one offers Washington a golden opportunity to wield this threat offensively—that is, to boost the odds of holding Beijing to its wide-ranging promises of better trade and commercial behavior. For example, if the United States decides that the Chinese aren't acting quickly enough to improve intellectual property protection or to halt technology extortion, or that they continue to impede U.S. agricultural exports with disingenuous safety regulations, the United States can retaliate however it wishes—including with punitive tariffs on Chinese goods. China's only legal recourse, leaving the agreement completely, would risk provoking even higher tariffs on many more products. Of course, this all-or-nothing provision permits the United States to use tariffs defensively as well. Suppose China decides to hike subsidies in order to increase certain exports to the United States, or simply to price the American competition out of its own market. The United States can retaliate with targeted tariffs or the trade equivalent of carpet-bombing, and all the Chinese legally can do in turn is

abandon the entire treaty and risk the kind of full-blown trade war they've been desperate to avoid. It's true that the Chinese could ignore the treaty's terms and try their own targeted tariff approach. But that would risk the United States waving goodbye and the treaty falling apart as well.

Nor do phase one's benefits for U.S.-based businesses and their employees stop with the all-or-nothing provisions, for the agreement also gives potential plaintiffs a guarantee of anonymity. One major reason for the long-time ineffectiveness of pre-Trump efforts to safeguard U.S. interests threatened by China was U.S. companies' fear of Chinese retaliation against their operations in the People's Republic. Phase one permits Washington to keep the names of any companies seeking action against China confidential.

Why Phase Two Is Unnecessary

Precisely because China needs the United States much more than the United States needs China—and because phase one capitalizes on this imbalance of economic power so ingeniously—there is absolutely no need for Washington to seek a phase two. Yes, additional talks could in theory further clarify Chinese obligations and even speed up certain compliance-related timetables. But even efforts to "nail down" treaty terms and develop foolproof terminology (whatever that means) are not worth the candle. They miss the enforcement point entirely—as they always have.

After all, enforcement problems with China have never had anything to do with inadequate language. They've had to do with the logistical impossibility of monitoring treaty compliance because of the vast size and tight secrecy of China's bureaucracy—which of course includes many enormous state-owned

entities. Think of it this way: how many American bureaucrats would we need to monitor the countless Chinese government agencies, state banks, and other entities to make sure that Chinese officials have rewritten their regulations correctly, that these instructions are being followed, and that no winks and nods to subordinates are tolerated? No one can count that high.

Phase one eliminates all of these problems, and effectively makes the United States judge, jury, and court of appeals on Chinese compliance. The insuperable conventional enforcement challenge should also teach a broader China policy lesson: so-called gold-standard texts are unlikely to meaningfully change Chinese behavior. Even the most expertly crafted treaty cannot guarantee adequate enforcement. So phase one should be seen not as a means of eliminating Chinese economic abuses, but as a way of reducing the number of victims of these policies, especially among American manufacturers, service providers, farmers, and their employees. As a result, phase one helps advance the administration's goal of reducing America's reliance on China, for both economic and security reasons.

New Pressures on China

The question still remains why China agreed to such an unequal treaty. The answer is clear upon comparing its economic performance with that of America since the trade war began in 2018. Up until the coronavirus struck the U.S. economy, the United States was winning the conflict going away. As critics of the Trump tariffs noted, the U.S. economy did go through a soft patch in the spring and early summer of 2019. But after overall inflation-adjusted U.S. economic growth slowed from a robust 2.9 percent (annualized) in the first quarter of 2019 to 1.5 percent in the second, it

bounced back to 2.6 percent in the third quarter and 2.4 percent in the fourth quarter. The pandemic first began depressing economic performance in March 2020, but throughout that month, the Atlanta Federal Reserve's GDPNow was estimating first quarter 2020 growth back at over 3 percent. Inflation-adjusted output growth in U.S. manufacturing—the economy's most trade-affected sector—began slowing (year over year) somewhat earlier —in the fall of 2018, shortly after the first China-specific Trump tariffs came into effect in early July, and much more sweeping planned tariffs were threatened. Yearly real manufacturing growth slowed further and even briefly turned negative till the pandemic took effect. But more than the trade war was at work.

In March 2019, airlines across the country and around the world began grounding Boeing's popular 737 MAX jetliner, and slowing or halting orders altogether. The company's safety woes kept mounting and finally peaked in December, when Boeing announced that production on the model would be suspended completely beginning in January. The drying up of work throughout Boeing's vast domestic supply chain clearly weighed on overall American manufacturing production independent of the trade war, but even so, signs of resuming overall manufacturing expansion appeared as early as November 2019. Indeed, in February the Federal Reserve (which tracks manufacturing output) announced that without Boeing's troubles, manufacturing production for January would have increased by a decidedly healthy 0.30 percent month over month.

Also dragging on 2019 manufacturing output was a strike at General Motors that lasted nearly six weeks and hindered production not only in vehicles

and parts but for all the manufactured metals, plastics, rubber, chemicals, and electronic components from which they are made.

Similar patterns were evident in manufacturing employment. From 2018 (the year when Trump's China and metals tariffs both began) till 2019, annual industrial job growth slowed from 264,000 (the best such total since 1997's 304,000) to 59,000 (the worst such total since 2016's 6,000 loss, but a gain nonetheless). Moreover, the 2019 figures were somewhat depressed by the GM strike. (Aerospace employment excluding the parts, components, and materials for aircraft, aircraft engines, and aerospace-specific parts and components held up reasonably well during this period.)

In addition, U.S. domestic manufacturing added 147,000 jobs during the sixteen months after Trump's first batch of China tariffs came into effect. That's less than half the 319,000 added during the sixteen months before, but hardly the catastrophe some predicted.

Particularly intriguing signs of the trade war victory have come from the monthly manufacturing surveys conducted by various regional branches of the Federal Reserve system. These reports present so-called soft data—manufacturers' subjective views on whether their circumstances and performances are improving or worsening—rather than changes in actual output, employment, new orders, and the like. Such reports are taken seriously because they're more timely than the federal government's hard data releases, and tend to anticipate such hard data fairly well. These findings mainly indicated significant upticks in activity in early 2020 following the humdrum 2019. Since the phase one trade deal didn't even entail a reduction of the vast majority of the U.S. tariffs placed on Chinese

products, these surveys added to the evidence that U.S.-based industry was weathering the trade war just fine.

As for the consumer and business inflation widely expected from tariffs, nothing of the kind materialized. The trade war pessimists simply assumed that importers could pass all of these price increases on to consumers. What they completely overlooked was business's inability to recover their onetime pricing power because so many consumers have remained shell-shocked by the last financial crisis and its ruinous aftermath. Over the longer term, moreover, productivity improvements can enable industries to absorb whatever cost increases result from using more expensive U.S.-made materials, parts, and components and maintain profitability via greater efficiency.

On the other hand, the evidence suggests that China suffered much more damaging effects. Even though the numbers published by Beijing have usually overstated the nation's economic performance, recently they painted a picture of major deterioration.

When the Trump tariffs began, in July 2018, China's quarterly annualized economic growth rate was 6.7 percent. By the end of 2019, it had sunk to 6.0 percent. The full-year 2019 gross domestic product increase of 6.1 percent was the lowest such figure since 1990. In the middle of last year, moreover, Chinese industrial output—which includes production from utilities and mines as well as trade-sensitive manufacturing—hit a seventeen-year low.

Even more worrisome, the quality of China's growth was worsening, too. As the rate of economic expansion slowed in 2018, the share of that growth fueled by debt of all kinds kept mounting; China's total debt level is now nearly 3.2 times the size of its total economic output. The trade war seems to have played a major role in the country's increasing addiction to debt, as the increase in debt seen in 2019 followed two years in which Beijing sought to bring leverage under control. Ever more of this debt is being incurred by nonfinancial entities, like those in the trade-heavy manufacturing sector, further suggesting that the trade war deepened the country's reliance on debt.

Chinese employment data are notoriously unreliable, if only because of the difficulty of accurately measuring employment among the country's huge population of migrant workers, who staff factories as well as other kinds of firms. But in mid-2019, two studies, including one from one of China's state-run banks, conservatively pegged trade-war-related manufacturing job losses in the range of 780,000 to 1.9 million. Such losses would represent less than 1 percent of China's official payroll count, but they would be concentrated in a sector viewed by Beijing as crucial to its growth and modernization ambitions. These employment losses no doubt reflected growing trade-war-related pressures on Chinese commercial entities. Indeed, in 2019, Chinese industrial profits posted their first annual loss in four years. And almost certainly as a result of such slowing economic growth and weakening national finances, bad loans at China's overwhelmingly state-owned banks surged by more than 20 percent that year—after hitting a ten-year high the previous year.

Enforcing Phase One

Phase one's negotiation hardly means that Washington can rest on its laurels. Real success will depend on aggressive implementation—not simply monitoring and reporting Chinese violations of the agreement, but resolving to call Beijing's bluff and to pull the retaliatory tariff trigger when necessary. U.S. officials will certainly be kept busy by the ongoing need to prevent Chinese investment (which is all state-controlled to varying extents) from distorting America's still largely free market economic systems and financial markets. Clamping down on technology transfers and increasing American defense-related corporate investment will also take time. We will also have to continue pressuring our allies (formal and informal, like Taiwan) not to feed the Chinese beast with vital capital and know-how.

Someday, if this approach produces significantly and measurably better Chinese practices over a sufficient period of time, Washington could engage in a set of negotiations that might be called phase two—aiming at further economic renormalization. But not a moment sooner.

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