

Negotiation and Ratification: Hurdles Remain for China Talks and the USMCA

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Summary

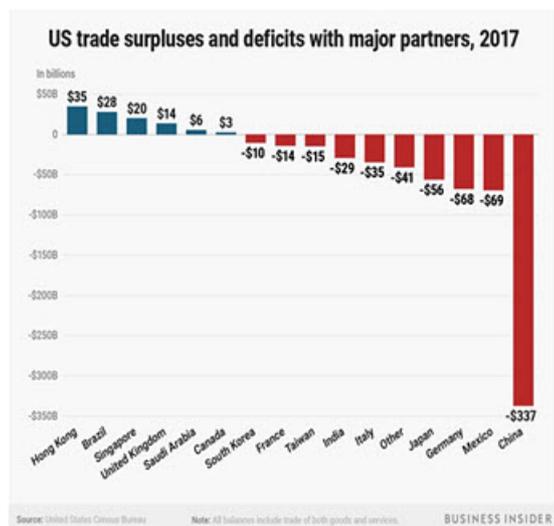
- Dealing With China
- Is The USMCA On Its Way?

To obtain an economics degree at the University of Chicago, students were required to take a year-long course in the history of a non-Western civilization. Economics is a social science, after all, and business cultures can vary widely from place to place.

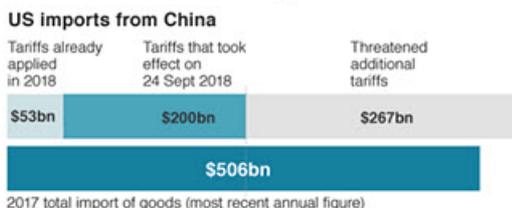
I elected to study Far Eastern civilization, primarily because Japan was rising as a business power when I attended college. Back then, there were suggestions that Japan would one day eclipse the United States, and I wanted to understand the secrets of its success. China, by contrast, was still seen as a backward country that, while rich in history, was poor economically. How times have changed.

One of our assigned texts during the unit on China was “The Art of War” by Sun Tzu. The book details secrets of military strategy, which occasionally involve annoying, confusing and provoking one’s opponent. I’ve been thinking about that approach quite a bit during the past year, as China and the United States work through difficulties in trade relations.

After initial rancor and a lot of confusion, trade talks between the world’s two largest economies have been proceeding productively. But while both sides are motivated to reach a deal, the final details are proving difficult to define. The situation remains the biggest risk to the economic outlook for the balance of 2019.



US and China’s tariffs against each other



Chinese imports from US



Note: Data as of 24 September 2018
Source: US Census Bureau, BBC research

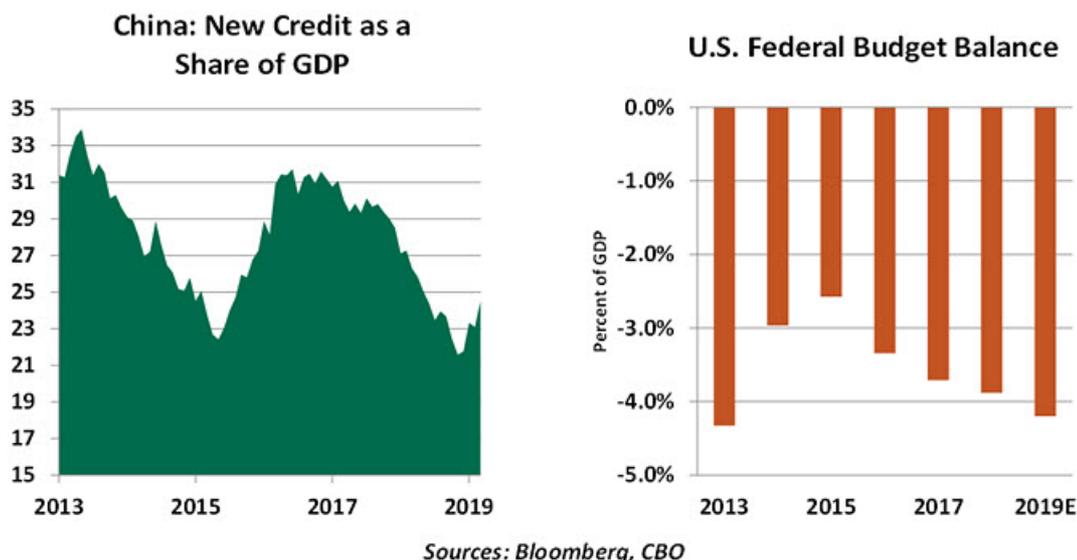
As we discussed recently, restrictive trade policy around the world has been a root cause of slowing global growth. China and the U.S. share the largest bilateral trade relationship in the world, one that affects a number of other countries. Economic détente between the two would be welcomed in a range of world capitals and markets.

The size of the U.S. trade deficit with China has attracted the ire of American policy makers. To be sure, trade deficits are not necessarily the result of unfair practices. They can result from natural causes, such as one country consuming at a greater rate than another. Some deficits in goods are offset by surpluses in services. Trade flows include cross-border production systems that make it difficult to identify countries of origin.

Some of these factors are at play in the U.S./China dynamic. But China's trade policies have been a source of global consternation. When China was granted entry into the World Trade Organization in 2001, it promised to open its markets, reduce state ownership and protection of domestic firms, and safeguard intellectual property. A number of countries around the world, the U.S. chief among them, contend these promises have not been kept. The current confrontation centers on these issues.

Initially, China and the United States took steps to annoy one another. Each enacted restrictive trade measures, seeking leverage in negotiations. The U.S. placed a 10% tariff on \$250 billion of Chinese imports, which has taken a toll on Chinese manufacturers. China placed tariffs on \$110 billion of American imports, with agricultural products a particular focus.

Both sides have enacted measures to soften the blow. Chinese authorities have implemented a range of financial stimulus programs that have stabilized economic growth and reduced their willingness to make concessions on trade. The U.S. has set aside billions of dollars to compensate farmers for types of crops that the Chinese have targeted. Additional deficit spending, the result of 2017 tax reform, has also muted the consequences of tariffs on the American economy.



After initial volleys, provocation gave way to negotiation. Both sides see economic and political benefits in reaching an agreement: for China, removing restrictions and easing uncertainty would boost their markets (Chinese equity markets have been among the world's best performers so far this year). It would also allow them to refocus on financial stability, which Chinese President Xi Jinping has equated with economic and social stability. China has accumulated a substantial amount of debt over the last ten years that will need to be reckoned with.

For America, equity markets have already prospered as trade talks have progressed. With the 2020 presidential campaign already underway, an accord could be a feather in the president's cap. And increased access to Chinese markets would benefit American firms and farmers. Given these prospective benefits for both sides, we think an agreement will be reached by mid-year.

The telecommunications sector (5G mobile network hardware and software, in particular) will not likely be covered by the accord. The Chinese have made leadership in this area an industrial priority, and are unlikely to retreat from it. U.S. warnings that Chinese equipment could be used for surveillance have not gained traction in world capitals. Hard-liners had hoped to arrest Chinese progress on this front, but appear to have lost the battle.

A remaining sticking point is how any new agreement would be enforced. It is one thing to monitor export flows; quite another to monitor adherence to patent protections and market access. China manages information carefully, and will be reluctant to open its books.

Any agreement would have to be ratified by the U.S. Congress, which is not a certainty. A weak deal would raise questions of whether the cost and economic dislocation caused by tariffs were worth it. And a failure of the accord to limit anticompetitive behavior on the part of the Chinese would attract opposition from industry.

In sum, a temporary trade peace between China and the United States is in the offing. But it would leave many key issues unresolved, and uncertainty would continue to surround the relationship. Third parties will have to continue trading carefully as they deal with either side.

But this outcome is preferable, on many levels, to an escalation of tensions. Quoting Sun Tzu, “The greatest victory is that which requires no battle.” Couldn’t have said it better myself.

New Label, Same Contents

Recognizing the need to contemporize with evolving tastes and preferences, leading consumer-products companies repackage and rebrand existing products. It works for some, but not for all.

Politicians also employ this practice periodically, as exemplified by the U.S.-Mexico-Canada Agreement (USMCA). The White House is marketing the USMCA as a significant new trade deal, but it is merely a rebranded version of the two-and-a-half-decade-old North American Free Trade Agreement (NAFTA). The question is whether the U.S. Congress will buy the updated offering.

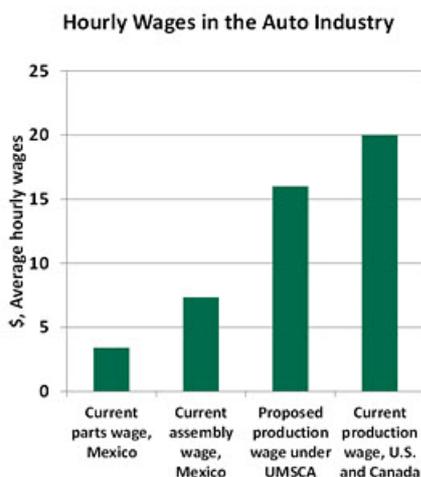
The original NAFTA was instrumental in eliminating a majority of tariffs and barriers across different sectors. Trilateral trade within North America increased from \$352 billion in 1994 to \$1.3 trillion in 2018. NAFTA allowed the formation of efficient supply chains and lowered prices for consumers, but its detractors in the United States claim it has resulted in a substantial loss of factory work.

Though much of the USMCA remains consistent with NAFTA, some improvements were warranted. NAFTA was implemented at the dawn of the internet in 1994; hence, it lacked provisions to deal with digital trade. This is one area where the new agreement adds value. The USMCA includes provisions that address data flow, protection of intellectual property rights, e-commerce and cybersecurity.

Other important provisions of the USMCA include tighter rules of origin for the automotive, textile and apparel sectors and liberalized agricultural exchanges. Though each of the three signatories made concessions, they were not very substantial. The net impact on trade and overall economy will likely be modest for all three countries.

The new rules of origin in the auto sector (which include labor content requirements) are unlikely to yield any notable benefits. In fact, the updated guidelines could increase production costs and push the sourcing of vehicles and parts outside the region. Higher labor costs in Mexico’s auto sector could contribute to employment losses on both sides of the border, as manufacturers seek to implement more equipment as a way of avoiding higher labor costs.

The U.S. International Trade Commission (ITC) estimated that the USMCA would raise annual U.S. real gross domestic product by \$68.2 billion and create 176,000 employment opportunities, relative to a baseline where NAFTA remains in place. In relative terms, this translates to a mere 0.35% and 0.12% increase respectively. The ITC concluded the deal would offer little help in reducing the trade deficit with Mexico and Canada, a critical issue for the president.



The USMCA is not an economic game changer, but may be a political lightning rod.

Sources: IMFDOT, Center for Automotive Research, USA Today

The overall impact on Mexico and Canada is also expected to be limited. That said, Canadian businesses aren’t quite content with the new agreement. According to the Forum Research survey, more than half of Canadian business leaders think the original NAFTA was better for the Canadian economy than the new deal.

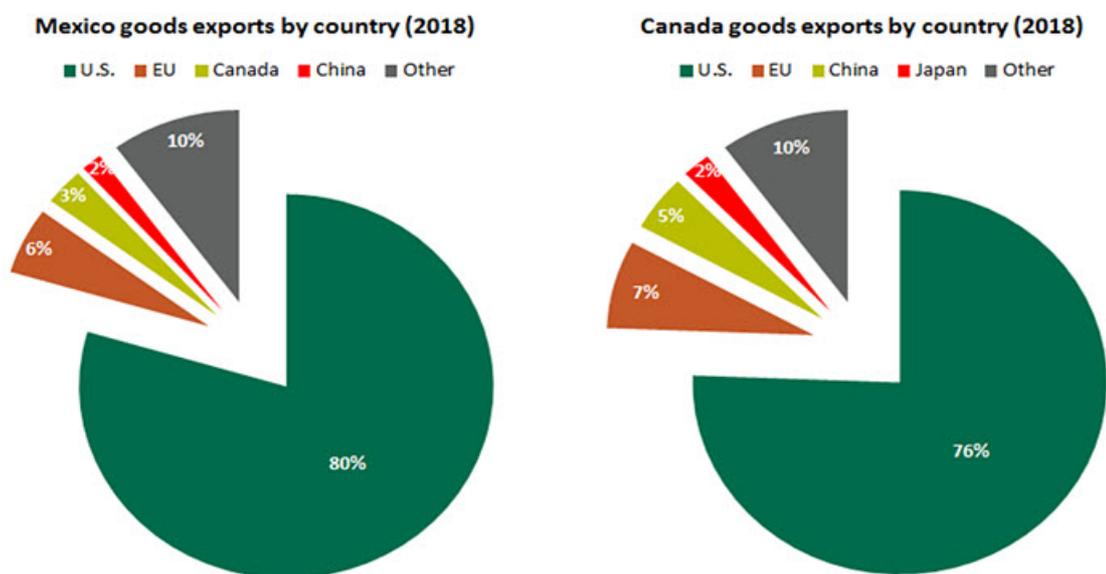
Though the release of ITC analysis has cleared one procedural hurdle before the U.S. Congress can consider USMCA, the road to ratification won’t be an easy one. None of the three governments have yet ratified the accord, and appear in no hurry to do so.

In the U.S., both supporters and opponents of the agreement have used the ITC report to bolster their respective positions. The analysis will likely help the representatives who have withheld their support, fearing the USMCA would be seen as a net negative. Pressures from businesses that would benefit from the agreement, particularly the politically sensitive auto and agriculture sectors, will also work in favor of passage.

On the other side, opponents of the agreement and the administration will continue to raise objections on the grounds that it delivers much less than expected and potentially damages some industries. Members of Congress have also started raising questions about the ITC’s methodology and analysis. Political incentives related to the 2020 U.S. elections will complicate upcoming discussions.

Continuance of steel and aluminum tariffs is the biggest obstacle to the passage of the USMCA in Mexico and Canada. Both nations have asserted they will not ratify the deal until these tariffs have been lifted, which the administration has been reluctant to do. Even as the battle over the tariffs continues, the U.S. Department of Commerce is planning to open a new anti-dumping probe into fabricated structural steel from Canada, China and Mexico.

U.S. Trade Representative Robert Lighthizer has said that failure to ratify the USMCA would “be a catastrophe” for the U.S. If it fails, the administration might attempt to unilaterally withdraw from NAFTA, which economists think would be a greater catastrophe. The dissolution of the existing arrangement would lead to significant disruption in commerce and employment and significant adjustment costs for a number of industries (the auto industry, in particular). Needless to say, it would also result in much higher prices for consumers in all three countries.



Source: Oxford Economics

We expect the USMCA to be ratified eventually. But it could take longer than anticipated, and the political environment across North America creates substantial uncertainty.

There is nothing wrong in updating or putting a new wrapper around an old product, but mere repackaging doesn’t always guarantee success. Politicians can use the art of marketing to put their points across, but they should be mindful of the consequences. The rebranding of NAFTA might not be to everyone’s liking, but the new deal is far better than no deal at all.

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