2020.1.20 (nle2020.1)

Newsletter

Institute for International Monetary Affairs
公益財団法人 国際通貨研究所

US-China "Phase One" Trade Agreement and Chinese Economy in 2020

Naoki Umehara
Senior Economist
umehara@iima.or.jp
Emerging Economy Research Department
Institute for International Monetary Affairs (IIMA)

1. US and China trade negotiations: The first phase deal was signed

（1）Background to signing

The trade frictions between the US and China developed in a way that the US imposed the higher tariffs in three phases from July to September 2018, on the total \$250 billion worth of Chinese goods, to which China imposed retaliatory tariffs successively. In parallel, the two countries had a series of minister-level consultations, and in April 2019 they almost reached an agreement on the consensus document, but as China instantly canceled the deal, they went back to a new start, then the US imposed in September 2019 additional tariffs on the \$120 billion equivalent of goods. Furthermore, in December the US showed its intention to take more action on China but both countries reached an agreement on the deal of Phase One[1], which was signed on January 15th 2020.

（2）Outline of the agreement

The agreement, however, was a tentative and partial compromise. China promised to improve its transparency of foreign exchange intervention and opening of financial market, in addition to its cooperation with the US to reduce its trade deficit by purchasing total \$200 billion worth of

[1] The formal English title is "Economic And Trade Agreement Between The Government Of The United States Of America And The Government Of The People's Republic Of China" and in Chinese 中华人民共和国政府和美利坚合众国政府经济贸易协议. Refer to the following URL for original texts.
https://ustr.gov/sites/default/files/files/agreements/phase%20one%20agreement/Economic_And_Trade_Agreement_Between_The_United_States_And_China_Text.pdf（HP of the Office of the USTR）
http://images.mofcom.gov.cn/www/202001/20200116104122611.pdf（HP of Chinese Ministry of Commerce）

US foods, agricultural products and others. However, there was no reference to the industrial subsidies and the rulemaking for cyberspace nor scrapping of additional tariffs by the US. The unsettled issues were postponed to the future negotiations.

2. Impact of continuing higher tariffs on corporate activities

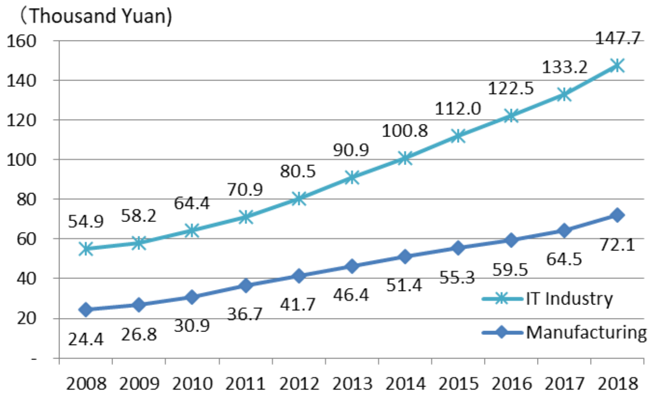
（1）Tariffs rate remaining high

The agreement of Phase one did not eliminate the 25% additional tariffs imposed on the $370 billion worth of US imports and 7.5% additional tariffs on $120 billion worth of imports, and the higher rates will be maintained. The average tariff rate of the US on Chinese products was 3.1% on a monthly average in January 2018, but it will be higher at 19.3% after February 2020 until the next conclusion of negotiations[2]. The fact is likely to exert great influence on the business judgement of export-oriented manufacturers located in China. It is concerned that these manufacturers will accelerate shifts of their production lines out of China.

（2）Plight of export companies

The production cost of manufacturers in China has been rising since the middle of the 2000s. The average wages have risen almost three times in 10 years since 2008 (Figure 1). While the rise of wages contributed to an improvement of living standard of urban citizens, it resulted in a loss of cost competitiveness which helped to drive up China to a "factory of the world". Furthermore, especially private export-oriented companies that had originally experienced severe funding environment faced further deterioration of business climate due to the start of US-China trade wars, some of which fell into default and were forced out of business.

Figure 1：Average Wages of Urban Workers



（Source）National Bureau of Statistics of China

[2] The average tariff rate levied on the US products that China imports was 8% in January 2018, going to rise to 20.9% since February 2020. "Phase One China Deal: Steep Tariffs Are the New Normal", Chad P. Bown, December 19, 2019, Peterson Institute for International Economics (PIIE)

（3）Impacts on foreign affiliated companies

The deal also necessitated foreign affiliated companies to reconsider their strategies, including review of supply chains. In May 2019 a US based Oracle cut the number of employees working at the research and development office in Beijing[3]. In June Apple of the US requested its major suppliers to consider shifting some of their production capacity of iPhone from China[4]. Taiwanese companies which were more sensitive to the change started to shift in 2019 their production bases back to Taiwan or to Vietnam, and a possibility is increasing that in 2020 other foreign affiliated companies from Europe and Japan also start to adjust their production bases or production lines for maximization.

Meanwhile, differing from the tariff issues, US-China conflicts over advanced technology like communication that is associated with military affairs also remain unsettled. Thus far, the Chinese government has promoted sophistication of industries while encouraging research and development by taking advantage of subsidies and trying to introduce advanced technologies from incoming foreign companies. However, it is highly likely that transfer of technology becomes harder for China and it will have to follow its own path of development. As a result, the decupling of technologies between the US and China will deepen, even involving Japanese companies. For instance, there is already a move that the US government specifies the Chinese companies associated with national security and orders the US companies to restrict their supply of parts to or purchase of products from those companies. If the US restrictive measures should extend to other foreign companies, there is a risk that the decoupling of the supply chains spread to the whole Asia.

3. Chinese economic management in 2020 and US-China trade negotiations

At the Central Economic Work Conference held in December 2019, “stability” had a top priority for the economic policies for 2020. 2020 marks the centennial anniversary of the establishment of Chinese communist party as well as a preceding year of the start of the 14th Five Year Plan. The last thing that the Communist Party wants would be that the economy and the society will be shaken at this important time.

However, the Chinese economy continues to be faced with downward pressures. The economic growth slowed to 6.1% in the 2019 full year, dropping by 0.6% point from previous year[5]. The quarterly developments show the growth for the first quarter of 6.4% over the

[3] “Oracle closes China R&D center as competition rises; some observers cite political factors” （May 7 2019, CNBC） https://www.cnbc.com/2019/05/08/oracle-is-laying-off-more-than-900-people-in-china-reports-say.html
“Oracle is laying off more than 900 people in China, reports say” （May 17 2019, Global Times, China） http://www.globaltimes.cn/content/1148929.shtml

[4] June 19 2019, Nikkei (limited to subscribers) evening scoop, “Apple considers shifting of manufacturing from China to Southeast Asia” (asks for its major suppliers to assess the cost implications of moving 15 -30 per cent of their production capacity from China.)

[5] In November 2019, National Bureau of Statistics of China published revised figure of nominal GDP for 2018. Later

corresponding previous quarter, followed by 6.2%, 6.0% and 6.0% in the following quarters, respectively. The deceleration seems to have stopped in the fourth quarter, but there is a possibility that it was helped by supporting policy measures.

The high customs tariffs could especially press the management of manufacturers located on the coastal areas, threatening to worsen their employment. Such a situation could easily come to the surface especially at around the time of the Chinese New Year's day. If workers anticipate a loss of job in the near future, they may either remain in the coastal areas to seek another job or move to their home villages or neighboring smaller cities with cheaper living cost to seek new jobs. The government, anticipating these moves, announced in December 2019 policy measures to promote employment.

This is not a situation where the government can enjoy peaceful and quiet situation, but rather the government will have to positively implement economic boosting measures to cope with downward pressures on the economy.

4. Conflicts will continue

Negotiations by the two countries will be restarted as early as in the middle of February 2020. China may aim at early removing of additional tariffs by the US which will damage Chinese economic growth and destabilize employment, but the US is seen to continue to put pressure on China to abolish subsidies in exchange for it, thus with no easy agreement expected. Export-oriented companies in China, including foreign affiliates, will have to prepare for their business plan assuming that the trade conflicts will continue for some time to come.

On the other hand, exodus of exporting companies from China may add another blow to the vulnerability of the Chinese economy. In 2019, some state-owned enterprises faced default on corporate bonds amid ballooning corporate debts. If the financial system should be destabilized by any chance in the face of slowing medium-and long-term economic growth, rapid capital outflows may cause a drastic depreciation of the Renminbi, which may affect the neighboring countries as well.

To orient the Chinees economy toward a soft-landing path, it is essential for the US and China to come back to the path of mutual trust and cooperation, quitting from the current relation of conflict and opposition. In order to make it happen, it is necessary for China to change its way of economic management and make the US government and public opinion soften their stance, but they still have a tough road ahead.

---

it modified the real GDP growth rate for 2018 from 6.6% to 6.7%. http://data.stats.gov.cn/index.htm

Address: Nihon Life Nihonbashi Bldg., 8F 2-13-12, Nihonbashi, Chuo-ku, Tokyo 103-0027, Japan
Telephone: 81-3-3510-0882, Facsimile: 81-3-3273-8051
〒103-0027　東京都中央区日本橋本 2-13-12 日本生命日本橋ビル 8 階
電話：03-3510-0882（代）ファックス：03-3273-8051
e-mail: admin@iima.or.jp　URL: https://www.iima.or.jp