

## The ‘Phase One Deal’: a truce that creates more problems than it solves

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### Summary

The trade agreement signed on the 15<sup>th</sup> of January between China and the United States is nothing more than a truce. It leaves additional tariffs on roughly two-thirds of US imports from China in place. Chinese pledges to purchase American products should help to reduce the bilateral trade deficit, but they will not necessarily bring back manufacturing industries to the US. They will, however, hurt third countries. Commitments on intellectual property rights, technology transfers and financial services will increase investment in China by American companies, if they have any significant impact at all. And China’s commitments to partially align with US practices on sanitary and phytosanitary standards, however sensitive they may be, will only have limited commercial consequences in terms of scope and will be restricted to the agricultural sector. In the absence of a dispute settlement system with credible institutions, the agreement fails to achieve lasting stability. A central problem, industrial subsidies, is not addressed, and the prospect of a ‘Phase Two’ agreement appears nebulous and uncertain. The agreement is yet another step that will destabilize the multilateral trading system, as it subjects trade relations to the bilateral political balance of power.



It was a campaign promise by Donald Trump that he kept: a trade 'deal' with China has just been signed. According to Trump, of course, the so-called 'Phase One Deal' is nothing short of historic. But a careful reading of this 96-page agreement leads to a much less enthusiastic conclusion: it is more like a truce than a peace agreement and contains only limited commitments that create more problems than they solve.<sup>1</sup>

One month after the WTO's Appellate Body ceased to function, two great powers are setting up a system for handling their bilateral trade that is largely managed—albeit without dismantling most of the additional tariffs that were previously put in place. Their agreement is another step that will destabilize the multilateral trading system, as it subjects trade relations to the bilateral political balance of power. The impact will ultimately depend on the extent to which it is able to achieve its objectives and on the reactions of third countries. Yet its potential implications warrant close scrutiny.

### ■ A truce, not peace

After an exhausting trade war with many twists and turns, there is no doubt that the possibility of a truce has brought some relief. Indeed, markets reacted very positively when the 'Phase One' agreement between the United States and China was announced on the 13th of December. The signal that there would be no further threats, sanctions and retaliation was in itself of great value, given the uncertainty and apprehension created by the Trump administration's trade policy towards China.

But the agreement is unlikely to usher in a period of lasting peace. For example, the US continues to impose tariffs—beyond the normally applied rate—on almost two thirds of imports from China. US concessions in this domain are limited to not applying the additional tariffs on 162 billion dollars of Chinese imports that had initially been scheduled for the 15th of December. Moreover, by the 14<sup>th</sup> of February, additional tariffs on another 100 billion dollars of imports, which had been in force since the 1st of September 2019, will be reduced from 15 per cent to 7.5 percent. But supplementary tariffs of 25 per cent on another 250 billion dollars of Chinese imports remain in place. We are therefore very far from a return to normalcy.

The future of these concessions is also in doubt, since they depend on the proper implementation

of the agreement. Unfortunately, the provisions on implementation and dispute settlement offer little guidance. The agreement sets up of a structured dialogue group for implementation, the so-called Trade Framework Group, which includes both high-level engagement and working groups. But comparable structures had existed since 2006, before Donald Trump decided to abolish them. The effectiveness of this arrangement is therefore questionable. As for dispute settlement: it involves the possibility of contesting the proper application of the agreement and, if necessary, appealing to the 'Bilateral Evaluation and Dispute Resolution Office' (BEDRO) of the opposing party. There can also be consultations, exchange of information and, if necessary, suspension of some concessions.

The agreement also provides that if a suspension is implemented 'in good faith', the party that is the victim of the suspension will not retaliate. But who decides on the definition of good faith in a bilateral agreement, when an institutional structure which would allow for arbitration by a third party is lacking? This is precisely what the World Trade Organization (WTO) does, but the Trump administration has been trying to muzzle its dispute settlement function. In the absence of an equivalent institution in this case, there is only one recourse: withdrawal from the agreement. This is explicitly mentioned as the ultimate remedy (Chapter 7, Article 7.4, paragraph 1).

In other words, this truce remains fragile, especially if the concessions obtained by the US are unsatisfactory over time; in order to assess the likelihood of this happening, the nature of the concessions and the relevant provisions must be examined in greater detail.

### ■ Intellectual property rights and technology transfer: significant commitments, but the real impact is questionable

The first two chapters of the agreement deal with the enforcement of intellectual property rights and transfer of technology, the two main issues which had motivated the procedure the United States initiated under Section 301 of the US Trade Act, the legal basis for additional tariffs imposed on Chinese imports.

The first chapter includes Chinese commitments to provide 'fair, adequate and effective' protection of intellectual property rights (Chapter 1, Article 1.2) and to facilitate remedies against abuse. Pharmaceutical products are subject to more specific commitments (Section C). The text is unambiguous and contains

(1) The full text of the agreement is available at: [https://ustr.gov/sites/default/files/files/agreements/phaseper cent20oneper cent20agreement/Economic\\_And\\_Trade\\_Agreement\\_Between\\_The\\_United\\_States\\_And\\_China\\_Text.pdf](https://ustr.gov/sites/default/files/files/agreements/phaseper cent20oneper cent20agreement/Economic_And_Trade_Agreement_Between_The_United_States_And_China_Text.pdf).

significant commitments exclusive to China. For the United States it simply states that its practices ensure treatment equivalent to that permitted by the rules set out in the agreement. China also commits to present an action plan within thirty days of the implementation of the chapter. While the text does not include a binding requirement explicitly calling for legislative change, some innovative provisions are worth highlighting, such as the definition and modalities of sanctions for the misappropriation of trade secrets (Articles 1.4 and 1.8), or the reversal for burden of proof in civil proceedings once evidence has been produced by the plaintiff (Article 1.5). Although it is unrealistic to assume real independence of the judiciary in China, it will be interesting to see how these commitments are implemented and what their real effects are. All in all, while this is clearly an important issue, the full scope of the commitments is uncertain. For several years now, China has been trying hard to build a system for the protection of intellectual property rights. In fact, it is a priority for the country, as China wants to turn innovation into its engine of growth. While the agreement will likely be an incentive to speed up the pace, tighten requirements and tackle malpractice, this undertaking will only bear fruit in the long run.

The difficulty of implementation is perhaps even more evident in the case of technology transfer, where the main commitments are not to 'require or pressure, formally or informally, [...] to transfer technology' (Chapter 2, Article 2.3). The problem, as stated precisely here, is that pressure in this area is very often informal, and therefore difficult to identify and control a fortiori. Moreover, on intellectual property and technology transfer, a number of the commitments in the agreement had already been enshrined in China's new law on foreign direct investment adopted in March 2019.

In regard to geographical indications (protected designations of origin and others), the agreement only contains provisions that aim to limit their scope (Chapter 1, Section F). This is not surprising, since the United States does not recognize the legitimacy of geographical indications. However, the provisions that outline China's commitments in future agreements (Article 1.15) are beating a dead horse, given that China has just signed an agreement with the European Union (EU) on this very subject on 6 November. Another clause provides that protected geographical indications, including obligations under an international agreement, could fall back into the common regime of generic indications, depending on 'how consumers understand the term in China' (Article 1.16). One can ask if this is a pebble thrown in the EU's pond, with the hope of subsequently using it to water down China's commitments in this area.

## ■ Sanitary and phytosanitary standards: partial Chinese alignment with US certification and practices

The chapter on sanitary and phytosanitary regulations and certifications contains a series of commitments by China on their nature and on the recognition of US certifications. Although not explicitly mentioned, this chapter clearly aims to prevent China from using sanitary or phytosanitary pretexts for protectionist purposes, a practice that is difficult to prove but widely recognized. For dairy, poultry, beef, pork, rice and aquatic products, the agreement therefore makes China's commitments to recognize US certifications explicit. The commitments include, for example, health certifications for dairy products and the traceability of beef. This is not insignificant, given the sensitivity of Chinese public opinion on food safety issues. However, it is essentially a recognition of the reliability of the US system.

Other provisions go much further and impinge on Chinese regulatory practices. For example, the agreement emphasizes the benefits of biotechnology and commits to 'maintain, for products of agricultural biotechnology, science- and risk-based regulatory frameworks and efficient authorization processes, in order to facilitate increased trade in such products' (Chapter 3, Article 3.1, paragraph 1.d). In other words, China pledges not to follow the European path on GMOs, even though there is some public reluctance to do so, and Chinese regulations have tightened in recent years, with negative consequences for exports from the United States, for example of corn.<sup>2</sup>

Another striking example is China's commitment to refrain from regulations that are more stringent than those approved by the Codex Alimentarius, or, in the absence of standard practices, on limits for hormone residues in beef (Chapter 3, Annex 4, paragraph 5). Once again, this is a commitment not to follow the EU, even though China has for several years been tightening regulations to limit abuses by farmers using hormones and growth promoters, as well as antibiotics.

## ■ Financial services: an opening, but who benefits?

The financial services chapter contains commitments by China on the conditions for the establishment and operation of US service providers in banking, electronic

(2) See, for example: <https://www.reuters.com/article/us-china-corn-imports-gmo/china-traders-cancel-u-s-corn-cargoes-on-tighter-gmo-controls-buy-from-ukraine-sources-idUSKBN1FT0US>.

payments, asset management and insurance. For many, these commitments simply reflect recent regulations. For example, a new regulation from last October allows the establishment of wholly foreign-owned (not just US-owned) bank subsidiaries. That said, the commitments are a response to the frustration of the US financial and insurance sector, which for years has tried to open the doors to a huge and potentially lucrative market. Companies like Visa, American Express and Citigroup have expressed their intention to enter the Chinese market for a long time. These commitments will undoubtedly reassure them. It remains to be seen, however, to what extent they will be able to take advantage of the opening. For foreigners, the Chinese market is difficult to understand, as it depends on a highly prescriptive and rapidly changing environment of regulations and government policies. It has also become very competitive. In electronic payments, for example, US companies may find it very difficult to gain a foothold in what is now the most developed market in the world.

## ■ Exchange rate manipulation: a label that has de facto been dropped

The agreement rings hollow on macroeconomic policies and exchange rates. Both parties commit to a 'market-determined exchange rate regime,' which is somewhat ironic. China makes no bones about administering its exchange rate, even as it tries to do so in a manner consistent with signals from financial markets. In substance, this chapter is not binding. Above all, it confirms that the United States has dropped the label of exchange rate manipulator that Donald Trump has long been using against China. Even the US Treasury Department referenced this decision two days before the signing of the agreement in its quarterly report. It was high time, since China stopped pursuing problematic exchange rate policies a full decade ago and few observers consider the Renminbi to be significantly undervalued today. According to CEPPII estimates, its exchange rate is 3.2 per cent below the equilibrium level, a very small gap (source: EQCHANGE database, CEPPII).

## ■ Import pledges: A return to managed trade will have little effect on the US multilateral deficit

Although this chapter is the penultimate section of the agreement, it is clear that quantified commitments on Chinese imports of US products are at the heart of the

concessions that the Trump administration obtained. The agreement sets targets for the cumulative increase in purchases over the next two years, totalling 200 billion dollars, for all major economic sectors: 39 per cent for manufactured goods, 16 per cent for agricultural products, 26 per cent for energy products and 19 per cent for services (including Chinese receipts from US financial and insurance institutions, see Annex 6.1, note f). In each case, the target is significantly more ambitious for 2021 than for 2020, and the stated intention is to extend these commitments until 2025 at a later stage. The Trump administration reportedly set informal targets at a much more detailed level, *i.e.* by major product (these have not been disclosed).

This approach, reminiscent of the voluntary import expansion commitments that the Reagan administration obtained from Japan, marks a profound break from rules-based agreements, which are a cornerstone of the multilateral trading system, in favour of outcomes-based agreements. The level of detail in the commitments even suggests a shift to a largely administered trading system. This approach is quite consistent with Donald Trump's long-standing positions. He believes that US trading partners are not complying with international rules and sees their constraints as an obstacle to leveraging his country's power.

Contrary to the stated objective—encouraging China to reform itself in order to move closer to the functioning of a decentralised market economy—the agreement contributes to a consolidation of state capitalism, since it is the government that commits to future purchases.

These commitments could well prove relatively effective in lowering the bilateral deficit of the United States *vis-à-vis* China. This certainly does not imply that the multilateral deficit, *i.e.* a negative balance of payments for all trading partners combined, would also fall (see below for more on this point). Undeniably, Donald Trump's aggressive stance is putting pressure on the Chinese government, and the willingness to ease tensions creates an incentive to work towards these attainable objectives, even though they are not without cost to China. Indeed, the state and the party have more than enough control over the economy to achieve these goals if they choose to do so. It depends, however, on whether the United States is able to provide sufficient supplies of what China needs—potentially a major stumbling block for the agreement. For example, given that China is the United States' largest export market, the projected increase in agricultural exports (12.5 billion dollars in the first year, 19.5 billion dollars in the second) is considerable when compared to the exports in 2017 (24 billion dollars for China as a whole, including Hong Kong). This is not necessarily easy to

implement, especially given that sales of soybeans, the leading export product, will continue to be hampered by a recent halving of the Chinese pig population due to the swine fever epidemic. Even in the manufacturing sector, China could cite US supply shortfalls as an obstacle to achieving the stated objectives. The agreement furthermore specifies that the US commits itself to 'take appropriate steps to facilitate the availability of U.S. goods and services to be purchased and imported into China' (Article 6.2, paragraph 4), which could potentially undermine US export restrictions on sensitive technologies, such as the prohibitions on Huawei and ZTE. Who will judge the good faith of the parties in this case?

### ■ 'America First' and others last: an agreement incompatible with the WTO, detrimental to third countries

These import pledges will clearly result in discrimination in favour of US producers and to the detriment of third country access to the Chinese market. The consequences can be expected to be very significant for exports from countries that are most exposed, such as Brazil, Argentina and Australia on agricultural products, as well as Japan, Korea and Taiwan on electronic products. The EU is likely not going to be affected directly, but it also has to expect to suffer from unfair competition, particularly in the aeronautics industry (if Boeing regains the supply capacity to significantly increase its sales), for machinery and capital goods, and for precision instruments.

The terms of the 'Phase One' agreement appear to be incompatible with the commitments in the WTO. Indeed, it is difficult to see any coherence with the most fundamental principle of the multilateral trading system, the most-favoured-nation rule: 'Any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties' (GATT, Article 1, paragraph 1). This agreement is clearly also not qualified to claim the exception allowed for regional trade agreements, which are supposed to eliminate tariffs on 'substantially all trade' between the parties (GATT, Article XXIV). Incidentally, they also appear to be in contradiction with the prohibition of quantitative restrictions (GATT, Article XI). These incongruities are not surprising, as they are coming from a president who frequently expresses his misgivings about the multilateral system, and from an administration that is trying to paralyse its operations.

### ■ The agreement is unlikely to reindustrialize the United States

From the outset, Donald Trump's trade war against China has been aimed at reversing the deindustrialization of the United States. Ultimately, Americans should therefore measure its success by this yardstick. How does it stack up?

Potentially most significant are quantitative import commitments, in particular on manufactured goods. Increase in Chinese demand is expected to create additional demand for American industry and boost production. The magnitude (78 billion dollars of additional demand over two years) corresponds to about 1 per cent of US manufacturing output. But the political framework for the bilateral relationship with China will not address the underlying reason for the US current account deficit, which is caused by a macroeconomic imbalance, namely insufficient savings relative to investment. 'Forced sales' from the US to China will therefore result in secondary effects that lead to an appreciation of the dollar and consequently reduce US sales on third markets and/or increase total US imports. The final result could therefore be the opposite of the desired outcome for the manufacturing sector, which is likely going to be most directly impacted by negative side effects.

The commitments on intellectual property rights and technology transfer mainly protect the investments by US companies in China. If they had a significant effect, it would paradoxically be to incentivise production in China rather than in the United States. The same is true for the provisions on financial services, which, moreover, do not apply to manufacturers.

All in all, it is difficult to see how this agreement could significantly contribute to the reindustrialisation of the United States. This is particularly the case because the agreement does not address the most fundamental problem with Chinese competition: industrial subsidies and state-owned enterprises. Perhaps there are plans to deal with this in the 'Phase Two' agreement. But this is impossible to know, since the substance of the second stage of negotiations has not been made public. As the content, modalities and timetable remain uncertain, this truce must be seen as a provisional arrangement that is bound to last. So much for the end of uncertainty.

The joint statement issued by the trade ministers of the EU-Japan-US trilateral on the eve of the signing of the 'Phase One' agreement gives hope that the US is finally considering the possibility of a joint approach with its partners to address the problems posed by industrial subsidies. While a cooperative response cannot be ruled out, it is too early to take it for granted.

## ■ As trade relations become politicized, the EU is confronted with a fait accompli

In the short term, the EU, like other third parties, will have to get used to a new environment: this agreement contributes to the growing destabilisation of the multilateral trading system and everyone needs to learn how to defend their interests pragmatically. The recent reforms of the EU's trade defence instruments, the direct investment screening mechanism, the creation of a chief trade enforcement officer and the discussions on reciprocity in public procurement all point in this direction. The proposed reform of the EU's implementing rules for international trade ("enforcement regulation") shows that this adaptation continues, by making it easier for the EU to deal with deadlocked situations, in particular to take rebalancing measures in response to protectionist measures, in spite of the paralysis of

the WTO Appellate Body.<sup>3</sup> Even if it is not sufficient, it would be a useful reform, provided it is used with care to create incentives to return to a rules-based system, and not become the tool of a bidding war in which the whole world would lose. Because rather than marking the end of all tensions, this 'Phase One deal' has further emboldened the role of politics in trade relations.

(3) "Proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 654/2014 of the European Parliament and of the Council concerning the exercise of the Union's rights for the application and enforcement of international trade rules", European Commission, 12 December 2019.

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