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USD/CNY – Welcome to Managed Trade

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Key Points:

- Phase 1 almost certainly violates WTO norms
- In particular, MFN (most-favored nation)
- There is no way now to adjudicate MFN using WTO, which has been neutered by Trump and USTR Lighthizer
- With then a temptation for disputing parties to use national courts – one way to disrupt global trade even without additional Tariffs
- China's purchase agreements for US goods & services over two years:
 - USD32bn of ag goods, with an additional USD10bn "letter of comfort"
 - USD78bn of manufactures
 - USD52bn of energy, and
 - USD38bn of financial services, as Christmas came a little late
- China has committed itself to more than double any amount of ag goods it has ever bought from Americans
- Ag futures didn't seem particularly convinced
- The language of phase 1 does seem a little skewed towards Americans

What Happened

Full text

The full text of the US-China phase 1 agreement can be found [here](#).

Managed Trade

Managed Trade / MFN

Before we go into analysis, we offer a couple of Big Thoughts. The *Washington Post's* David Lynch (who has consistently provided useful reporting throughout the Trade Wars) [beat](#) us to it, but we had been pursuing the same thought in our mind (as seen by the title of this note).

Phase 1 occasionally alludes to following WTO rules, **but there is no way this can be true**

With this deal, and despite prefatory promises in the text for

... *adherence to international norms so as to promote market-based outcomes*

there is no way this can be true. Despite phase 1 text occasionally declaring adherence to World Trade Organization (WTO) principles, Team Trump has dealt its most powerful blow yet *against* global free trade (which was once a bedrock US Republican Party position in most of the post-World War II years, till recently). While USD200bn is not a trillion, when it comes to world trade it's big enough to move the needle and, more importantly, to be noticed.

What China has committed to is almost surely a violation of MFN

Longer-time followers of China will remember that old, quaint tradition when, before WTO re-accession, the US had to re-certify every year it would treat China as an MFN (most-favored nation, which was how the US treated almost every other country in the world). MFN is basically a promise to not discriminate against **nor for** any nation, relative to all other nations. Those who might describe MFN as the protein that make up the body of global trade are not going far enough. We think of MFN as more like amino acids. There is no way China will suddenly discover, this and next year, non-discriminatory reasons to buy enough American goods and services to meet its commitments, no matter what both sides may claim. **What China has committed itself to is almost surely a violation of MFN.**

The WTO Is a Dead Ship in Water; or, You Thought Tariffs Were the Only Way to Muck Up Trade

Lighthizer has ensured WTO is a dead ship in water

Now again in the old days (more than three years ago), if your trading partner violated MFN, you would go to the WTO to file a complaint and try to adjudicate the issue. But Trump, and especially Lighthizer, has made sure there is no more recourse to that. By refusing to nominate judges to the WTO's appeals body, Lighthizer has made sure the WTO is now a dead ship in the water. In the first years of the Trump Administration there were informative [articles](#) on Lighthizer's background and strategy, which laid out this particular aim. We have spoken to senior staff at the WTO in recent months who still believe this is his intention.

Without WTO adjudication, it will be tempting to use national courts to adjudicate justice, one way to disrupt trade

As said, China diverting USD200bn of export flows can be expected to be noticed (heck, even USD2.4bn of French wine gets noticed), and when nations (eg, the EU) find they have no recourse to the WTO, what do you think they will do? Take their lumps and commiserate on losses? Dream on. Without a global adjudication process, it strikes us it will be extremely tempting to try to pursue justice using your own national courts. The thought of Europeans seeking justice in their own courts while Americans defend themselves in US courts strikes us as the exact sort of process that will disrupt global trade **further** (hence why the supply chain will still shift). And you thought Tariffs were the only way to disrupt global trade.

China's Purchase Commitments

CHINA'S PURCHASE COMMITMENTS IN PHASE 1

ANNEX 6.1 INCREASES IN U.S. EXPORTS TO CHINA OVER 2 YEARS			
Unit: USD Billion			
Product Category	Additional U.S. Exports to China on Top of 2017 Baseline		
	Year 1	Year 2	2-Year Total
1. Manufactured Goods	32.9	44.8	77.7
1 Industrial machinery			
2 Electrical equipment and machinery			
3 Pharmaceutical products			
4 Aircraft (orders and deliveries)			
5 Vehicles			
6 Optical and medical instruments			
7 Iron and steel			
8 Other manufactured goods ^a			
2. Agriculture^b	12.5	19.5	32.0
9 Oilseeds			
10 Meat			
11 Cereals			
12 Cotton			
13 Other agricultural commodities ^c			
14 Seafood ^d			
3. Energy	18.5	33.9	52.4
15 Liquefied natural gas			
16 Crude oil			
17 Refined products			
18 Coal ^e			
4. Services^f	12.8	25.1	37.9
19 Charges for use of IP			
20 Business travel and tourism			
21 Financial services and insurance			
22 Other services			
23 Cloud and related services			
TOTAL	76.7	123.3	200.0

Source: USTR

It was a *quid pro quo*

The *quid* matched pre-signing promises of USD200bn over two years

We'd been particularly focused on Chinese ag purchase commitments: USD32bn, with a USD10bn "letter of comfort"

But the Chinese added a "market conditions" opt-out

USD78bn of manufactured goods

USD52bn of energy

And USD38bn of financial services round out the post-Christmas shopping list

At its crassest, phase 1 was always going to be, at its core, a

Quid, which are Chinese purchases to appease the Trump base; for a Quo, which is a Trump pause on Tariff escalation plus a Reduction from 15% to 7.5% on 1 September 2019 Tariffs.

Chinese purchases are buried in the back of the text and, in aggregate, matched pre-signing reporting for an additional +USD200bn of US purchases in 2020-21. Details, however, were slightly different than anticipated.

There is an incremental USD32bn of Chinese ag purchases committed for 2020-21, USD12.5bn in 2020 and USD19.5bn in 2021, to be measured against a 2017 baseline. There is also another good-faith promise to buy USD10bn more, USD5bn each in 2020 and 2021, buried in a table footnote. This allows Team Trump to stay consistent with the USD40-50bn they had been trumpeting. Trump continues to sell USD50bn to his base on the campaign trail.

But in the text the Chinese said they'd only meet these ag commitments based upon "market conditions," by which we think they mean depending on whether the price is right and seasonalities of the ag trade.

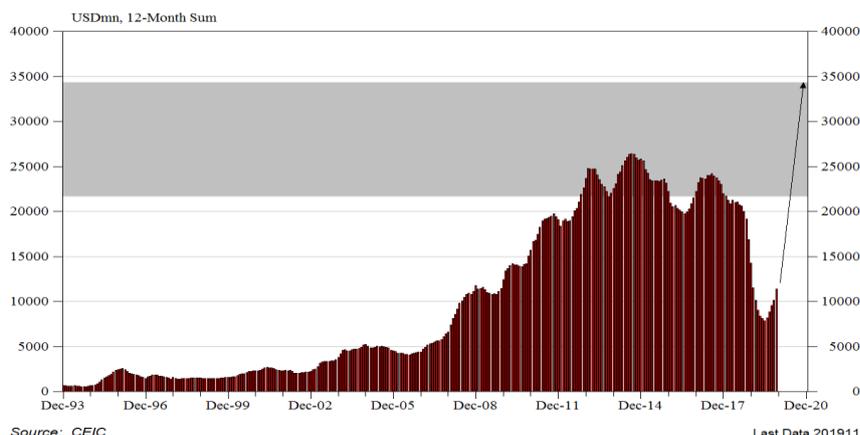
Pre-signing, Reuters reported the Chinese would purchase USD80bn of US manufactured goods over two years. It turned out slightly less, at USD77.7bn, with a list of Harmonized Tariff codes for the included manufactures within the text.

Pre-signing, reporting said the Chinese would buy USD50bn more of energy from the US over two years. It turned out a little more, USD52.4bn. We expect Team Trump will want the Chinese to buy less from Iran; we wonder if this will affect the Saudis as well? If it's natgas, Australians may not be happy.

Finally, there is a commitment to buy USD37.9bn in financial services (pre-signing, word was USD35bn). Financial services, of course, has been a longstanding Chinese carrot dangled in front of Americans and to the world, beginning right from WTO get-go 19 years ago. Several large Wall Street banks were represented at Trump's signing press event.

A HIGH HILL TO CLIMB

Value of All China Ag Imports from the USA



Source: CEIC, MUFG Bank

The Chinese have committed to more than double any previous amount of ag goods they have ever bought from Americans

In the chart above, the bars are rolling 12-month sums of all Chinese imports of agricultural goods from the US, using the HS system of classification in the phase 1 text. The collapse of Chinese purchases during the Trump Trade War illustrates Chinese retaliation; why US farmers and other food exporters (like lobsters; lobsters are specifically mentioned in the phase 1 text) have been hurt so badly; why Trump has had to extend, so far, USD28bn of relief payments to farmers (which helped 2019 US farm incomes to their highest level since 2013 but which did not prevent a rise in US farm bankruptcies); and why Trump has so heavily emphasized agricultural purchases as a part of phase 1.

The chart above shows you how high the hill is in 2020; in 2021, it'll be higher

The lower boundary of the greyed out zone is the 2017 baseline purchase amount of just under USD22bn. We add the USD12.5bn of targeted ag purchases for YE2020 to show how high a hill the Chinese will have to climb to meet their commitment. As the chart shows, the Chinese have committed to, by far, an all-time record of ag purchases from the US. And that's not even considering 2021, when the hill will be much higher.

If you can believe that; hard-nosed ag traders don't seem convinced

Despite supportive equity rallies before and after the phase 1 signing, among some of the most hard-nosed Markets traders we know, in agricultural futures, futures prices of commodities affected by phase 1 commitments have hardly moved (in [*The Wall Street Journal's*](#) words, that dog didn't bark; it could still bite, though).

Keeping Secrets

The family secrets of phase 1 were not released

As had become known, there are quantitative targets by product that are hidden in classified annexes to the table above, which were not released as a part of signing. When we first got wind of this (via a Fox Business News tweet), we were flummoxed, but we have since learned of a handful of historical precedents for secrecy in the history of US trade agreements:¹ A secret tax agreement during the Tokyo Round of GATT negotiations (1979); and a couple of agreements on sugar during the original NAFTA (1992), whose release were delayed by some weeks and months. The main point, however, is that secret annexes are very rare in US trade.

Making it more difficult for us in Markets to figure if the deal sticks

When Fox Business News first revealed the secrecy, it said it was on behalf of the Chinese. Whether it was the Chinese or USTR or both who insisted on this, at first blush we cannot fathom a good reason to insist on secrecy except to make it harder for those of us in Markets to discover if phase 1 has been violated, or not.

Losing Face

Phase 1 text does seem to be skewed in favor of the Americans

In the phase 1 text, though there are flourishes here and there to save Chinese face, and subject to the underlying truth there are no winners in a Trade War, the released text does seem to us to be one-sided, in favor of the US.

No further American Tariff cuts, and who knows how long it'll take to get to phase 2?

Note there are no US Tariff commitments in the phase 1 text (the *quo*). As had been reported, there is very likely **no** further Tariff cuts before the US 3 November 2020 Presidential election, so our earlier call there'll be occasional sightings but no clear evidence of phase 2 (or as we like to call it, Nessie) in 2020 seems essentially correct. US Treasury Secretary Mnuchin is now talking about phase 2 in terms of phases 2a, 2b and 2c, so we have no idea how long phase 2 will take, even if we get a second Trump term.

¹ We thank Professor Gary Hufbauer of the Peterson Institute of International Economics in Washington, DC, who for many years has been a scholar at the intersection of trade economics and policymaking, for educating us.

The assumption is for Chinese standards to catch up to America

And US laws and standards are *always* assumed up to snuff, with a standard text phrasing of:

The United States affirms that existing U.S. measures afford treatment equivalent to that provided for in this Article.

In other words, it's for China to bring its standards up to the US's; the sufficiency of the latter is assumed.

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