What's In the "Phase One" Agreement with China and What Comes Next?

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On January 15, 2019, President Trump and Chinese Vice Premier Liu He signed the long-awaited “phase one” trade deal at the White House. The deal represents the first step towards a comprehensive agreement between the two nations and progress in the U.S.-China relationship. The deal will help ease trade tensions signaling a truce in the trade war, at least for a while. The signing also marks the beginning of “phase two” negotiations, which will almost certainly be more contentious. “Phase two” will not be completed before the November election.

The Agreement

The agreement has eight chapters, including chapters on (1) intellectual property, (2) technology transfer, (3) agriculture, (4) financial services, (5) macroeconomic policies and exchange rate matters and transparency, (6) expanding trade, and (7) bilateral evaluation and dispute resolution.

As part of the agreement, the United States has already postponed a 15 percent tariff that was scheduled to be imposed December 15th on $160 billion of Chinese imports. The United States has also agreed to reduce tariffs on an additional $120 billion of Chinese imports from 15 percent to 7.5 percent. The reduction is set to take place February 14, 2020, according to a draft Federal Register notice from the United States Trade Representative. The agreement commits China to increase purchases of U.S. goods and services by $200 billion over 2017 levels. This includes $77 billion in manufactured goods, $32 billion in agricultural goods, $52 billion in energy, and $37 billion in services over the next two years. All purchases will be at market prices, and market conditions will dictate the timing of purchases.

The intellectual property chapter covers trade secrets, pharmaceuticals, patents, trademarks, geographical indications, and the enforcement of pirated and counterfeit goods. Specifically, it expands the scope of trade secret misappropriation liability, shifts the burden of proof requirements in civil cases, and adds criminal penalties for willful misappropriation. It also creates a mechanism to resolve pharmaceutical patent disputes early in the process and extends the effective patent term of patents experiencing delays in the Chinese approval process. The agreement requires that China increase its civil and criminal penalties to levels sufficient to deter intellectual property violations.

The technology transfer chapter covers various practices the United States determined to be unreasonable or discriminatory. China has agreed to end the practice of forcing foreign companies to transfer their technologies to Chinese firms as a condition for obtaining market access and administrative approvals. The chapter requires China to enforce its technology transfer laws in an impartial, fair, transparent, and non-discriminatory manner. China must publish the rules of procedure, provide parties adequate notice, allow parties to review evidence and respond, and allow parties to have legal counsel for the proceedings.

The agriculture chapter covers structural barriers to trade separate from China’s increased purchase obligations. The provisions should increase U.S. food, agriculture, and seafood exports and market access. The provisions aim to increase American farm and fishery income and promote job growth nationwide. The deal removes barriers for U.S. beef, pork, poultry, processed meat, rice, seafood, and pet food, among others.

The financial services chapter allows U.S. financial service providers to compete fairly and expand in the Chinese market. The chapter covers a broad range of financial services including banking, insurance, securities, and credit rating services, easing restrictions U.S. firms currently face in China. The provisions of this chapter also require China to eliminate foreign equity limits for securities companies, fund management companies, and U.S. life, health, and pension insurance providers.

The macroeconomic policies and exchange rate matters and transparency (currency) chapter requires both parties to refrain from competitive devaluations and targeting exchange rates for competitive reasons. The chapter also reaffirms the parties’ commitments to disclose relevant data publicly and refers conflicts on these issues to the dispute resolution system. The United States removed China’s currency manipulator designation earlier this week.

The agreement also includes a chapter on dispute resolution. Enforcement has always been problematic in agreements between the United States and China. The chapter creates a Trade Framework Group to discuss high-level implementation issues and a Bilateral Evaluation and Dispute Resolution Office in each country to deal with low-level implementation issues and settle disputes. The dispute resolution process begins with the complaining party launching an appeal. Designated officials from the opposing party’s Bilateral Evaluation and Dispute Resolution Office then assess the appeal. If those officials cannot resolve the issue, the appeal escalates to the Deputy United States Trade Representative and the designated Vice Minister, and then to the United States Trade Representative and the designated Chinese Vice Premier. If they cannot resolve the dispute, the complaining party can suspend obligations under the agreement or adopt a proportionate remedial measure. If the suspension or remedial measure was made in good faith, retaliation is not allowed. The parties may withdraw from the agreement if they believe the action is taken in bad faith.

Next Steps

While the agreement is a step in the right direction, the trade war is far from over. According to President Trump, the “phase one” agreement only covers about half of the relevant issues both sides wish to see addressed. Many of the “phase two” issues are more complex and controversial. These issues include Chinese government subsidies, intellectual property theft, state control of the Chinese market, and discrimination against foreign firms. In the meantime, U.S. tariffs will remain in place on approximately $370 billion of Chinese goods. Both sides will be extremely reluctant to give ground on many of these issues without gaining significant benefits.

“Phase two” negotiations are set to begin shortly now that “phase one” has concluded. The President noted, however, that the United States and China would not complete the agreement before the upcoming November election.

The success of “phase two” will depend in part on how the United States and China implement the “phase one” agreement. If both countries keep up their end of the bargain and the enforcement provisions effectively resolve any disputes, negotiations will likely continue in earnest. If the parties ignore their commitments and the dispute resolution process proves toothless, the chances of concluding a comprehensive “phase two” agreement will diminish significantly.

There are also concerns that some of China’s commitments are infeasible. The commitment to purchase an additional $32 billion in agricultural products, for example, represents a massive increase over the highest level of trade between the United States and China. China’s ability to purchase such a large amount of agricultural products is uncertain. To do so, China would likely have to divert imports from current sources, distorting trade worldwide. The language of the agreement seems to contemplate this. It notes that Chinese purchases are subject to market conditions and WTO rules. It also notes that the United States must ensure that it will make available enough goods and services to allow China to meet its purchase obligations. This suggests that parties may view these amounts as ambitious targets, not ironclad purchase commitments.

The other purchase requirements also raise questions about implementation including questions such as how much, to whom and when? Many details need to be addressed before progress on “phase two” can be expected.

With the “phase one” agreement complete, tensions should ease for now. This first step towards ending the trade war is an important one, but implementation will be the true judge of its success.