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The U.S.-China "Phase One" Trade Deal: Part I

After months of negotiations, the U.S. and China signed "Phase One" of what is expected to be a multiple-phase trade deal. After noting media response to the agreement, we were struck by the dismissive consensus narrative that has developed. Our careful review of the document seemed to suggest a much more substantial arrangement had been struck and the general analysis missed a good deal of nuance. In this report, we will offer a detailed recap of the official agreement. We usually don't engage in this sort of point-by-point analysis but, in this case, we feel it is necessary because points may have been overlooked. Next week, in Part II, we will examine the implications of the deal, and, as always, close with market ramifications.

Intellectual Property

Even though President Trump has touted China's commitment to ramp up U.S. imports under the deal, and media analysts have emphasized the U.S. promise to postpone or roll back its tariffs against China, the first 16 pages of the 94-page agreement focus on protecting intellectual property. That suggests U.S. Trade Representative Lighthizer's top priority was to rein in China's longstanding efforts to soak up foreign technology and industrial secrets by hook or by crook. It probably also signals the U.S. intention to pursue fundamental changes in China's legal system and industrial structure over time. The key provisions agreed upon include:

Scope of Actors Liable for Trade Secret Misappropriation. To make more entities subject to punishment if they misappropriate trade secrets, the deal requires China to include "all natural persons, groups of persons, and legal persons." The provision would prohibit China from looking the other way when favored individuals, state-owned enterprises or government officials are found engaging in intellectual property theft. As is the case with dozens of provisions in the deal, the text notes that U.S. law already complies with the stated requirement.

Scope of Acts Constituting Trade Secret Misappropriation. The deal requires China to prohibit more types of intellectual property theft, including "(a) electronic intrusions; (b) breach or inducement of a breach of duty not to disclose information that is secret or intended to be kept secret; and (c) unauthorized disclosure or use after the acquisition of a trade secret under circumstances giving rise to a duty to protect the trade secret…" Again, the text notes that U.S. law already complies with the stated requirement. In fact, the provision can be read to require China to adopt the U.S. legal concept of duty-to-protect when it comes to sensitive commercial information.

Burden of Proof in Trade Secret Misappropriation Suits. In contrast with China's current practice of requiring the holder of an intellectual property right to produce evidence and prove it was stolen, the deal requires China to shift the burden of proof to the accused party once the right

holder makes a credible claim of misappropriation. Again, the text notes that U.S. law already complies with the stated requirement, so the effect of the provision is to make China move closer to U.S. legal procedures.

Protection of Confidential Information by Government Authorities. Under the deal, China must require its administrative agencies "at all levels" to better protect confidential business information. Such agencies must limit information requests to the minimum necessary to carry out their investigative or regulatory authority. They must also limit access to the submitted information to only those officials who need it to carry out their duties. They must ensure the security and protection of the submitted information. Finally, they must "ensure that no third-party experts or advisors who compete with the submitter of the information or have any actual or likely financial interest in the result of the investigative or regulatory process have access to such information." The text notes that U.S. law already complies with these and other requirements in this section.

Pharmaceutical Patents. The deal requires China to consider supplemental data from other jurisdictions, markets or products when deciding on the patentability of a pharmaceutical. When utilizing such information, Chinese patent authorities must notify current patent holders, licensees and other intellectual property holders that data related to their property is being used and give them the opportunity to claim infringement. The text notes that U.S. law already provides for such measures.

Online Piracy and Counterfeiting. The deal requires China to beef up its procedures against counterfeiting and the online piracy of intellectual property. For example, China must require the expeditious takedown of infringing websites and remove any liability for intellectual property right holders who submit takedown requests in good faith. When pirated or counterfeit goods are intercepted, China must ensure that they are destroyed. Such measures would align Chinese practice with U.S. practice.

Technology Transfer

The U.S. was able to impose certain obligations aimed at ensuring that the transfer of technology occurs on voluntary, market-based terms. For example, the agreement states that, "Neither Party shall require or pressure persons of the other Party to transfer technology to its persons in relation to acquisitions, joint ventures, or other investment transactions." Both sides are also required to strictly protect any technical information disclosed by the other side's companies during administrative or regulatory processes.

Food and Agriculture Trade

The third chapter of the agreement aims to prevent China from using nontariff barriers to impede the importation of U.S. food and agriculture products. This large chapter delineates specific, detailed rules for a wide range of farm and food products, such as:

Beef. The agreement requires China to recognize the U.S. beef and beef products traceability system. Within one month of the agreement coming into force, China must also permit the importation of most beef and beef products inspected by the U.S. Agriculture Department (USDA) through its food safety inspection service.

Pork. Within 10 days of the agreement coming into force, China must permit the importation of pork and pork products inspected by the USDA's food safety inspection service.

Animal Feed. Under the agreement, China must allow the importation of U.S. feed additives, premixes, compound feed products and distillers' dried grains from USDA-approved facilities.

Biotechnology. Within one year of the deal coming into force, China must "establish and make public a simplified, science- and risk-based, efficient safety-assessment procedure for approval of food ingredients derived from genetically modified organisms."

Financial Services

The agreement seeks to leverage the U.S. financial services sector's high competitiveness by opening up China's banking, finance and insurance industries:

Banking. When a U.S. financial firm's qualified subsidiary applies to provide investment custody services in China, the deal requires Chinese regulators to consider the parent company's overseas assets in order to meet asset requirements. When a U.S. financial firm applies to serve as a debt underwriter in China, the deal requires China's regulators to consider the U.S. firm's overall international qualifications. Meanwhile, the U.S. promised to expedite Chinese applications to provide banking services in the U.S.

Credit Rating. Under the deal, China must allow U.S.-owned companies to provide credit-rating services in China. In addition, "Each Party shall allow a supplier of credit-rating services of the other Party to acquire a majority ownership stake in the supplier's existing joint venture."

Insurance. No later than April 1, 2020, China must remove the foreign equity cap in its life, pension and health insurance industries and allow wholly U.S.-owned insurance companies to participate in those industries. China must also "remove any business scope limitations, discriminatory regulatory processes and requirements, and overly burdensome licensing and operating requirements for all insurance sectors." The U.S. commits to expedite Chinese applications to provide insurance in the U.S.

Securities and Asset Management. By April 1, 2020, China must remove the foreign equity cap in its securities, fund management and futures industries and allow wholly U.S.-owned firms to operate in them. China is also prohibited from imposing discriminatory restrictions on U.S. futures dealers or private fund managers. In a move that may allow U.S. firms to participate in the cleanup of China's massive distressed debt problem, China will let U.S. firms apply to become asset managers with the right to buy nonperforming loans directly from Chinese banks.

Exchange Rate Policy

Under the agreement, both the U.S. and China promise to "refrain from competitive devaluations and not target exchange rates for competitive purposes, including through large-scale, persistent, one-sided intervention in exchange markets." They also promise to continue publishing frequent, regular updates on their foreign reserves and components of their financial account (direct investment, portfolio investment, etc.). Any violation of these commitments can be referred to the dispute mechanism discussed below. If that doesn't resolve the issue, the complaining party can request the International Monetary Fund to initiate an investigation.

Chinese Import Commitments

The provisions above constitute slightly more than half of the deal's 94 pages.

Although the media has focused on China's vow to boost imports from the U.S., the section dealing with that promise only covers the next 23 pages. In 2020 and 2021, the deal requires China to increase its imports of U.S. manufactured goods, agricultural commodities, energy products and services by $200 billion over their 2017 levels (see Table 1 and Figure 1). U.S. exports to China were close to $200 billion in 2017, so the extra $100 billion per year represents a compound annual growth rate of approximately 13.9% from 2017 to 2021.

Table 1.

U.S. Exports to China: Phase I Deal
Billions of $
Sources: U.S. Census Bureau, USTR

	2017 (Actual)	2020 (Promised)	2021 (Promised)	2017-2021 CAGR
Agriculture	24.0	36.5	43.5	16.0%
Energy	11.6	30.1	45.5	40.7%
Services	57.6	70.4	82.7	9.5%
Manufacturing	87.1	120.0	131.9	10.9%
Subtotal	180.3	257.0	303.6	13.9%
Not In Deal	7.7	???	???	???
Total Exports	188.0	???	???	???

Figure 1.

The text shows China has committed itself to boosting a wide range of imports, even if its targets for particular products have not been released. In ***agriculture***, China has agreed to import hikes across categories including corn, wheat, soybeans, barley, cotton, beef and beef products, pork and pork products, milk and dairy products, as well as vegetables, fruits, shellfish and wine.

In ***energy***, it promised to boost imports in categories ranging from crude oil and natural gas to coal and propane. In ***services***, it has promised increased purchases in categories ranging from software and data storage to travel, insurance and management consulting.

China's promised import increases in ***manufacturing*** are especially intriguing. While the deal commits China to higher imports of U.S. machinery, electrical equipment, pharmaceuticals and other manufactured goods, its vehicle commitments are limited to increased imports of fully assembled aircraft and autos. It appears the U.S. didn't want to encourage China to buy more of the subassemblies, components and parts that might support its indigenous aircraft and auto industries. Rather, it seems the U.S. wanted to constrain China's ability to build its skills in the final assembly of such important products.

Enforcement & Dispute Resolution

Finally, the deal calls for the U.S. and China to form a Trade Framework Group (TFG) charged with monitoring the agreement and resolving any disputes. The TFG would consist of the U.S. Trade Representative and Chinese Vice Premier. The two sides must also designate lower-level officers to serve as points of contact to help resolve disputes on a day-to-day basis.

If either side thinks the other is violating the deal, the complaining side can appeal to the other's lower-level point of contact. This even applies to cases in which the other side's action began prior to the agreement. In other words, China would have to use this procedure to complain against the multiple U.S. tariffs imposed against China since 2018, which aren't specifically mentioned anywhere in the document. The responding

side is then required to conduct an assessment, after which the designated officials begin consultations.

If the appeal can't be resolved by the designated lower-level officials, it is raised to a higher level of officials. If it still can't be resolved, it is raised to the TFG. If the dispute can't be resolved at that level, the complaining side has the right to take remedial action "in a proportionate way that it considers appropriate with the purpose of preventing the escalation of the situation and maintaining the normal bilateral trade relationship." If the accused side then determines that the complaining side is acting in good faith, it may not adopt any countermeasure or otherwise challenge the action. If the accused side determines that the complaining side is acting in bad faith, the remedy is simply to withdraw from the agreement. In other words, if China were to complain about continued U.S. tariffs against it, the U.S. could simply brand the complaint as "bad faith" and walk away from the deal.

Part II

This overview of the new trade deal may seem dry and specific, but we thought delving into so many particulars would help demonstrate just how broad and detailed it is. We hope the discussion provides a good understanding of what is in the agreement, separate from the Chinese import commitments emphasized by the press. Next week, Part II of this report will discuss some of the reasons why the two sides came to this agreement and how the U.S.-China trade relationship is likely to evolve in the future. Of course, we'll conclude with a discussion of the implications for investors.

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