ARE YOU PREPARED FOR THE OUTCOME OF THE U.S.-CHINA TRADE WAR?

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DONALD GROSS LAW

INTERNATIONAL TRADE COUNSEL

1701 Pennsylvania Avenue NW, Suite 200 • Washington, D.C. 20006
(202) 768-9824 • don@donaldgrosslaw.com
www.donaldgrosslaw.com

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After nearly two years of a potentially catastrophic conflict over tariffs and trade, the U.S. and China signed a breakthrough "Phase 1" agreement on January 15th that could lay the foundation for a long-term comprehensive settlement.

For exporters, importers, manufacturers and investors who are heavily involved in U.S.-China trade, the recent agreement provides potentially immense benefits – but still doesn't end their uncertainty or anxieties about what the future may bring.

Every participant in U.S.-China trade should now be reassessing his or her own expectations and strategic plans for not only surviving the trade war but, as importantly, for maximizing business success.

Clearly, preparation is essential for businesses to thrive and avoid suffering substantial harm at a time when critical political, economic and legal factors beyond a company's control are constantly changing.

To help business owners and senior executives shape business and legal strategies tailored to their company operations, I'll first clarify what the U.S. and China have decided and what is still in play. I'll then lay out possible scenarios and the strategic approaches that executives should consider taking to protect themselves and position their businesses for future success.

The New Phase 1 Agreement

Under the signed agreement China will:

- Buy at least $200 billion of additional US exports in goods and services over the next two years, on top of amounts it imported in 2017, in the following areas:

- $78 billion of *manufactured goods* including vehicles and industrial machinery
- $52 billion of *energy products,* including crude oil and LNG
- $32 billion of *agricultural and food products*
- $38 billion of *financial and business services*

- Open its financial sector by abolishing limitations on foreign ownership of Chinese securities by April 1, 2020 and ensure market access on a non-discriminatory basis for US securities, insurance and fund management companies.

- End its longstanding practice of requiring US companies to transfer technology to Chinese companies as a condition for obtaining market access

In exchange, the U.S.:

- Suspended a planned tariff scheduled to go into force on December 15th covering $156 billion of apparel products (Tranche 4B) and lowered the tariff rate from 15 percent to 7.5 percent on another group of apparel products (Tranche 4a)

The signed Phase 1 deal also requires China to:

- Adopt an action plan to make major structural changes for protecting US intellectual property

- Implement a dispute resolution mechanism that puts in place "strong procedures" for the US and Chinese parties to resolve disputes fairly and expeditiously

Under the Phase 1 agreement, the U.S. will maintain its current tariffs of 25 percent on $250 billion in Chinese products and 10 percent on an additional $300 billion of Chinese consumer goods.

FUTURE SCENARIO #1: The U.S. and China Reach a Phase 2 Deal & Comprehensive Settlement

Without question, the Phase 1 agreement signed on January 15th is a game-changer for U.S.-China trade relations – the likely beginning of the end of the trade war.

Phase 1 represents the first time since the opening shots of the trade conflict, approximately 20 months ago, that the parties have found common ground and enshrined it in a binding legal agreement. With public expectations for a complete settlement raised by both President Trump and President Xi, negotiators are now incentivized to reach agreement on the remaining U.S. and Chinese demands.

Even though most previously existing tariffs still remain in place, it is now *realistic* to anticipate a broad negotiated settlement in a Phase 2 deal that includes a sharp reduction in tariffs, Chinese implementation of necessary reforms, and a far more balanced U.S.-China trade relationship. A settlement of this kind would significantly expand business opportunities for American companies to export more products to China and to import more Chinese products to the United States.

Consequently, both exporters and importers can and should now formulate and implement plans as part of their business strategies for improved trade relations with China that seemed highly unlikely and unrealistic only a few weeks ago.

<u>U.S. Importers</u>

To prepare for the possible elimination of high tariffs imposed by the U.S. and China during the trade war as well as other beneficial reforms, key executives of U.S. importers should ask the following questions:

- How can we expand the quality and quantity of Chinese products we import?

- To what extent will a sharp reduction of tariffs improve the competitiveness of the products we import in various U.S. market sectors?

- If Chinese companies curtail their practice of forcing transfer of U.S. intellectual property, how will this help us expand our China-based supply chain?

- If the Chinese government significantly reduces its subsidies for competitive Chinese companies, what kind of openings for increased imports will this create?

- In what ways can and should we encourage our Chinese business partners to invest in the U.S. by building factories here for which our company could handle marketing and distribution?

U.S. Exporters

To take advantage of China's Phase 1 agreement to buy $200 billion in U.S. export products during the next two years on top of amounts it imported in 2017 as well as to prepare for the elimination of high tariffs in Phase 2, key executives of U.S. exporters should ask the following questions:

- How can we expand the quality and quantity of products we export to China?

- In what sectors of the Chinese market will the products we export become more competitive?

- How will the potential reduction of government subsidies to our Chinese competitors allow us to penetrate the China market more effectively?

- In what areas should we explore new relationships with Chinese companies for producing finished products that include the American intermediary goods we export?

- To what extent will a full Phase 2 settlement of the trade war and the reforms accompanying it enable the U.S. government to modify the controls it currently imposes on specific exports?

FUTURE SCENARIO #2:
The U.S. and China continue their negotiations for a Phase 2 deal but find it difficult to reach agreement

Despite agreement on a Phase 1 deal, the tensions and uncertainty of U.S.-China negotiations mean the U.S. and China may face complications and delays reaching a meaningful Phase 2 deal requiring new Chinese commitments and an end to high U.S. tariffs.

Factors that could slow down the process of reaching a Phase 2 agreement include various threats by the Trump administration:

- Delisting Chinese companies from U.S. stock exchanges

- Blocking a range of public and private pension funds and university endowments from making certain investments in China

- Putting other capital controls on U.S. private sector investment in China to protect against opaque Chinese company accounting and business practices

- Broadening scrutiny of potential Chinese investments in the United States on national security grounds

- Expanding checks by the Securities and Exchange Commission (SEC) of Chinese companies that do business in the U.S.

The tensions and uncertainty of U.S.-China negotiations mean the Phase 2 agreement may not be finalized and signed by the end of 2020.

- Disrupting the flow of capital between Hong Kong and mainland China if China does not adequately respect the autonomy of Hong Kong

Each of the U.S. measures described above would likely cause China to take reciprocal retaliatory actions – just as China has responded to U.S. tariffs with reciprocal tariffs of its own on American products.

At stake in the Phase 2 negotiation are issues that will determine whether the Trump administration achieves its core objectives in the trade war, including:

- Stricter rules to strengthen information security for cross-border data flows of American companies that do business in China

- Limiting the subsidies by China's government to state-owned companies which facilitate unfair competition

The issue for Phase 2 that is likely of greatest importance to American importers is whether an agreement removes U.S. tariffs on more than $500 billion in Chinese products that threaten the well-being of their businesses.

Given the uncertainty of reaching a follow-on Phase 2 agreement, key executives of U.S. importers and exporters should ask the following questions:

<u>U.S. Importers</u>

- If a Phase 2 agreement with China does not materialize, how should we plan to modify the sourcing of products we currently import from China to avoid high tariffs?
- What kind of exploratory discussions with suppliers outside China should we initiate as a hedge against uncertainty and continuing tension in U.S.-China trade relations?

- To prepare for a possible shift in import strategy, should we participate in the Customs Trade Partnership Against Terrorism (CTPAT) program that reduces the number of Customs examinations, accelerates Customs processing times and expedites border crossing privileges?

- What measures can we take to lower cost and raise efficiency to improve the competitiveness of Chinese-origin products in the U.S. market?

- Does our supply chain include middlemen who resell products to us at a marked-up price? If so, can we utilize the established "first sale rule" under U.S. law that allows us to avoid paying any duty on the amount of the mark-up?

U.S. Exporters

In light of continuing uncertainty about the Phase 2 negotiations, exporters should ask themselves:

- How can we modify the quantity and type of our exports to China in light of unfair competition from state-owned companies receiving government subsidies?

- If existing Chinese tariffs remain in place for the foreseeable future, how will that affect sales of our products in the Chinese market?

- How will increased U.S. controls on exports of American products to China affect our business strategy?

- If the U.S. imposes new tariffs on China and China retaliates, how can we manage and mitigate the likely negative impact on our sales in China?

- In light of the trade obstacles we now face and may continue to face, how should we modify our export strategy for China?

FUTURE SCENARIO #3:

The U.S. and China break off discussions on a final Phase 2 settlement of the trade war after negotiations fail and they pursue hostile trade policies toward each other

If the U.S. and China cannot reach a meaningful trade agreement in 2020, it is likely they will break off negotiations and pursue hostile trade policies toward each other. In this case, some or all of the following economic and political developments are likely to occur:

- The trade war will evolve into a major, multifaceted dispute – the equivalent of a cold war – that involves geopolitical and security disputes as well as trade issues

- Both the U.S. and China will find it difficult to stop a vicious cycle of retaliation and counter-retaliation on trade and other issues

- China and the U.S. will strive to consolidate their own trade blocs that exclude the other country – potentially decoupling the U.S. and Chinese economies/financial sectors
- China will enhance the role of its state-owned businesses using increased subsidies

- The U.S. will significantly expand its restrictions on trade with China by delisting Chinese companies from U.S. exchanges, blocking public and private U.S. investments in China, enacting much more restrictive export controls, ending most Chinese investment in the United States, exercising greater scrutiny by the SEC of Chinese companies and taking other restrictive measures

Outlook for Importers and Exporters

While future events could potentially reignite the trade war and eventually lead to a breakdown in U.S.-China relations, this dire prospect *should not be the immediate focus of planning and preparation* by importers, exporters, manufacturers and investors. The collapse of normal economic and trade relations represented by Scenario #3 is only likely to occur *after* China and the U.S. go through an extended period of uncertainty, tension, and deterioration in trade relations described in Scenario #2.

Companies involved in U.S.-China trade should therefore base their business and legal planning on the high probability that the trade war will likely evolve either toward a *settlement* of most outstanding issues or toward *continuing uncertainty* characterized by the inability of negotiators to resolve remaining differences.

It would be a major mistake at this time to take a "wait and see" approach or bet exclusively on either Scenario #2 or Scenario #3 coming to pass.

For this reason, importers, exporters, manufacturers and investors should focus on modifying their business/legal strategies to take advantage of the potentially immense benefits of the Phase 1 agreement and preparing contingency plans for either a Phase 2 agreement or the occurrence of Scenario #2 in trade negotiations with China – the two scenarios that are most likely to materialize between now and the end of 2020.

Donald Gross is founding partner of Donald Gross Law, an international trade law and strategy advisory firm in Washington, D.C. (https://www.donaldgrosslaw.com). He participated in U.S. negotiations with China as a Senior Adviser for International Security Affairs at the State Department from 1997 to 2000, and as Counselor of the U.S. Arms Control and Disarmament Agency from 1994 to 1997. He is the author of "**The China Fallacy: How the U.S. Can Benefit from China's Rise and Avoid Another Cold War**" *(Bloomsbury, 2013). He can be reached at don@donaldgrosslaw.com.*

If you'd like a free 30-minute consultation to help prepare for the outcome of the U.S.-China trade war or to review your business goals, current challenges and options, click here.