KIEP Opinions

The Impact of COVID-19 on the U.S.-China Phase One Agreement

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Although the novel coronavirus (COVID-19) originated in China, now it is affecting over 200 countries and territories all over the world. The COVID-19 pandemic reaffirmed that we are living in a highly integrated globalized world. Since both are global risks related to China, we can think about COVID-19 in connection with the U.S.-China trade dispute. The U.S.-China trade war, which had been escalating since early 2018, seemed to abate when the two countries reached their first agreement in December 2019. Following this, the two countries signed a "phase one" deal on January 15 which came into effect on February 14 this year. Right after implementing the phase one agreement, the Chinese government also announced tariff exemptions on 696 items imported from the U.S., including pork, beef, soybeans, wheat, corn, ethanol, liquefied natural gas, crude oil, steel rails, and some medical equipment.

However, COVID-19 cast a shadow on further implementation of the phase one agreement. The threat of widespread mass-scale deaths and economic hardship has led to growing nationalist narratives and xenophobia in the global community, to which the U.S. and China have not been an exception. To the Trump administration, the COVID-19 outbreak simply confirms the belief that China poses a threat to the world and cannot be trusted to act responsibly. Equally, the Chinese government sees some U.S. moves to fight the virus as being politically and racially motivated to impede the rise of China.

The key to the phase one deal is that China will import an additional $200 billion of U.S. products and services above its 2017 levels over the next two years. However, on top of the U.S.-China trade dispute, U.S. production as well as China's consumer demand have been hit hard by the COVID-19 crisis. In these circumstances, fully realizing the phase one agreement between the U.S. and China seems quite unlikely. Regarding trade expansion between the two, the phase one agreement rests upon four pillars – agriculture, energy, manufactured goods, and services – and it will be hard enough for both China and the U.S. to fulfill their phase one commitments in all four aspects.

First, China promised to import from the U.S. an additional $12.5 billion worth of agricultural products in 2020 and $19.5 billion in 2021. On March 24, the USDA and the USTR announced in a joint statement that progress had been made toward implementation of agriculture-related provisions within the U.S.-China Phase One Trade Agreement. As we can see from China’s removal of additional tariffs on U.S. agricultural products in February, China’s intention seems to be to increase agricultural imports from the U.S. This is probably because the coronavirus crisis has hindered the domestic transportation of feed grains, while China has suffered from African swine fever for over two years and an outbreak of avian influenza (H5N1) earlier this year. But the real problem is the supply-side disruptions in the U.S. Because of COVID-19, U.S. farms are confronting three countervailing issues: labor shortage, trouble organizing transportation, and price drop. In an effort to curb the spread of infections, the U.S. government recently began to restrict visas issued to seasonal workers from Mexico, which serves as a key source for cheap farm labor in the U.S. As a consequence, U.S. farms are facing labor shortages in this planting season. Also, lockdown measures have caused difficulties in transporting grain within countries and across borders. More importantly, consumer demand for items like beef, chicken, and fish has plummeted as restaurants close indefinitely, driving down crop and livestock prices. Already mired in two years of debt, aggravated by trade war tariffs and climate-related disasters, scores of farmers have been forced out of business.

Second, China agreed to import additional energy from the U.S. to the amount of $18.5 billion in 2020 and $33.9 billion in 2021. The current oil price fall helps China to expand its current account surplus as the import bill drops, and to boost foreign reserves as China buys energy in U.S. dollars. It will also provide China with a positive demand shock just like implementing an expansionary fiscal policy. Weaker crude helps China lower the cost of logistics and infrastructure as well as save money on energy and petrochemicals. However, cheap energy complicates Chinese commitment to the phase one trade deal with the U.S., in which China agreed to buy more than $50 billion of energy goods by 2021. With oil prices tumbling more than 80 percent since January, China will have to buy more than five times the amount from the U.S. that they promised in January. Considering the plunge in global demand, it is unlikely that China will have such a high demand for energy. Furthermore, there are U.S. supply-side constraints. Even before the COVID-19 outbreak in the U.S., the American Petroleum Institute already warned the U.S. government that it will be unable to meet China's needs for energy products due to the nation's limited existing capacity. Moreover, the U.S. shale industry is facing bankruptcy due to collapsing crude oil prices on crashing global demand. In such a situation, it is hard to believe that U.S. oil companies will make the costly and high-risk investments needed to substantially increase their supplies.

Third, China consented to import about $78 billion of U.S. manufactured goods by 2021. However, there are no incentives for Chinese companies to buy additional U.S.-produced goods, as China still maintains high duties on U.S. imports. During the trade war, China repeatedly increased tariffs imposed on U.S.-made products, while lowering its tariffs toward non-U.S. products. China's average tariff rate on U.S.-manufactured products is 16.0 percent in contrast to 5.2 percent on products manufactured in other countries. Price-wise, U.S. products are the least attractive choice for Chinese buyers. Eventually, to fulfill the phase one agreement, China should mobilize state-owned enterprises (SOEs) to purchase more products from the U.S. However, this directly contradicts and undermines one of the U.S. government's biggest policy objectives: making China more market-oriented. The Trump administration has battled against non-market-oriented policies by the Chinese government and Chinese SOEs' practices that have resulted in damage to the rule-based international trade system. However, the closer the two countries get to achieving the deal, the further away the world steps back from the rule-based regime.

Lastly, considering the nature of the industry, it is needless to say that the two countries will not be able to expand services amid limited traveling and heightened protectionism and nationalism.

In sum, regarding the U.S.-China trade dispute, we can consider three COVID-19 aftermath scenarios. 1) Considering the difficult situations involved to meet the commitment, China might resort to extreme measures such as imposing import quotas to import more U.S.-made products. Some experts might argue that this violates WTO rules, but the U.S.-China trade war and the U.S.-China Phase One Trade Agreement all violate WTO rules in the first place so nothing is surprising about this at all. 2) There is a chance that the U.S. and China might start renegotiating the phase one deal based on Article 7.6.2 of the agreement, which calls for such talks “in the event that a natural disaster or other unforeseeable events outside the control of the Parties delays a Party from timely complying with its obligations under this Agreement.” 3) The U.S. has been able to maintain more than 20 percent of additional tariffs on $360 billion of Chinese-made goods, as robust domestic consumption and an economic boom in the U.S. have mitigated the negative impact of the tariff war. However, due to the COVID-19 outbreak, some U.S. import-dependent industries are beginning to ask for tariff relief. If the U.S. economy further worsens, the phase two trade talks may start sooner than expected in a bid to further ease tariffs between the U.S. and China. As all three scenarios are highly likely to affect the Korean economy, we need to keep paying close attention to future U.S.-China negotiations.