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Trading Complexity

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Key points

- This week we take a breather from commenting on the latest developments on the pandemic, the cycle and policy-making to focus on trade and investment relations between the US, China and the European Union, and more broadly the new conception of economic foreign policy under the Biden administration.

In her confirmation hearing Janet Yellen sounded quite belligerent on the trade relationship with China, expressing a readiness to use “a full array of tools” to deal with China’s “abusive, unfair and illegal practices” which would suggest that the Donald Trump era, on these issues, is not fully over. Still, while tension will remain significant, and we don’t expect the remaining tariffs from the previous administration to be rolled back quickly, we think that the new team in Washington DC will adopt a subtle attitude.

We draw from a paper co-authored by Jake Sullivan, Joe Biden’s new National Security advisor, “Making US foreign policy work better for the middle-class”. While the report considers that in the two decades before Donald Trump’s ascent US economic diplomacy failed to consider the adverse distributional effects of globalization at home, it still espouses a generic “pro-trade” approach and takes a nuanced view of China. The report breaks with the “America First” stance by recommending a strengthening of the multilateral system, in particular the WTO, with support from the US traditional allies. Biden will be tested quickly on this, since the WTO has just found against the US in a trade dispute with South Korea which dates back from the Obama administration. The new US President could take this opportunity to unlock the dispute-settling system of the WTO and draw on a common position established two years ago with the EU and Japan to reform its rulebook when it comes to state subsidies or forced technology transfers, two major causes of tension with China.

However, Biden’s leverage on China may not be massive. His team is not fond of unilateral tariff hikes, and financial sanctions are not a risk-free alternative to trade war. Moreover, his capacity to enlist allies against Chinese trade practices may be limited, now that the EU has discovered, with the Comprehensive Agreement on Investment (CAI) signed with Beijing, that they may not need to side with the US to get concrete results.

The CAI is of course a way for Beijing to put a wedge between the US and the EU, but beyond the geopolitical motive, it may reflect a genuine change of course in China on opening its market to foreign operators. There is a narrow path for a more cooperative approach on trade issues between China and the US. Overcoming mutual distrust over each other’s status on the world stage is the main hurdle, but we think international trade issues will be less explosive during the next four years.

"Foreign economic policy for the middle-class"

The economic team surrounding Joe Biden could not be further away from Donald Trump's on their fundamental attitude to international trade. Deep down, they are "free-traders". Janet Yellen expressed it very eloquently in a speech to the Asian Financial Forum on January 13th, 2020. After highlighting the fact that the tariff rollback triggered by the Phase One deal between Washington and Beijing was only partial and would be barely noticeable by consumers, she elaborated on the long-term consequences of the trade dispute as it increasingly affects technology businesses: *"if the US and China are unable to find common ground, the pace of technological advancement could slow and complicate the launch of new commercial applications*", impairing productivity growth at the global level. She is steeped in the classical theory of international trade, where the absence of barriers raises collective welfare by lowering prices for everyone and fostering innovation through competition and economies of scale, breaking with the mercantilist approach focused on bilateral trade deficits, espoused by the Trump administration, where international trade is a zero-sum game.

Against this fundamental view however, Yellen a year later in her confirmation hearing sounded quite belligerent on the Chinese issue. Two points stood out. First, a re-affirmation of the US opposition to "*currency manipulation*"; second, even more explicitly, her stated readiness to "*take on China's abusive unfair and illegal practices".* **Indeed, the generic "pro-trade" attitude of the incoming Treasury Secretary will have to compromise with the overall severe view of unfettered globalization developed by Biden's foreign policy team**. The report "Making US foreign policy work better for the middle class", published by the Carnegie Foundation last September and co-authored by Jake Sullivan, Joe Biden's incoming National Security advisor, is probably essential reading to understand the new stance in Washington DC.

The report starts from the premise that in the twenty years before Trump's ascent to power, US foreign policy has failed to promote the interests of the American middle class. The authors distinguish two phases. From the end of the second world war to the 1990s, the economic interests of the mass of the US population were aligned with the general goals of the US foreign and security apparatus. Promoting free-trade and supporting the development of allies opened markets for the US industry which emerged from WW2 in a dominant position. US manufacturing became a powerful tool to promote non-college educated people into the middle-class. In the second phase though US foreign policy continued to push the same economic agenda without noticing that globalisation was having adverse distributional effects at home, particularly by eroding the domestic manufacturing sector.

The report is nuanced, making it plain that what is often too rapidly attributed to globalisation is actually the product of technological change, but we found one of their points striking*: "Congress votes on trade agreements, not on technology change"*. In other words, even if some of the anger at unfettered free trade is misguided, that the political debate focuses on this aspect is unavoidable. In the same vein, the authors acknowledge that globalization supported US households' purchasing power by reducing the price of goods, but they argue that this was drowned in the middle class' sense of struggle in the face of rising housing, education and medical costs.

The authors do not advocate an all-out pushback against trade. In their view, trade policy needs to be recalibrated to take on board the distributional effects of globalization, but the fundamentals of the old pro-trade strategy remain valid and are still broadly supported by the US population. Their report mentions a poll from 2019 according to which 76% of Democrats and 71% of Republicans consider that the US involvement in the global economy is a good thing because it provides the US with new markets and opportunities for growth. Even a significant majority (64%) of those with high school education and below supported this view. The report is a call for "a fairer deal" when it comes to trade relationships, seeking a level-playing field and taking on board social and environmental issues.

Sullivan and his co-authors also bring a similar sense of nuance to their general approach to China. True, they repeat the usual strategic containment doctrine, but with some important caveats. The country is presented at the same time as security threat, an economic competitor and a global partner: *"China's ambition for greater regional hegemony and its huge economy make it an ongoing potential source of major shocks and antagonistic power plays. On the other hand, China is essential to devising solutions to common problems",* for instance the fight against climate change. They develop a subtle and quite frankly quite theoretical policy line where the US would protect its own interests – including freedom of access to supply, which is a potential source of tension in the South China sea, or promoting a "level playing field" when it comes to market access, another source of conflict – but without taking the risk of "burning bridges" with Beijing. From that point of view, they differ from the hawks' view, which considers direct confrontation with China is ultimately unavoidable.

However, on trade issues proper, at first glance it might be difficult to see a big difference with the China policy adopted by Trump. His trade war may have served the interests of the defence hawks in the US administration, but his immediate goal was to force China to buy more American products, and ultimately Trump de-escalated with Beijing with the "Phase One" deal. Arguably, Trump was already defending the interests of the American middle-class there.

There is however a major difference in the *tactics* deployed to contain China in the economic realm. The "America first" strategy pursued by Trump resulted in practice in unilateral tariff hikes followed by countermeasures from the US suppliers, which cost was ultimately borne by US consumers and producers, creating in turn thorny distributional issues. The American agri-business may have benefited in the end from China's commitment to buy more soybeans, but US industries relying on imported steel, or hit by retaliatory tariffs, were worse-off. There is little appetite in Biden's team for a continuation of Trumpian tactics. **The report advocates a reform of the multilateral architecture**, particularly the World Trade Organisation, to exert more pressure on China to deliver on the level-playing field, together with an alliance with other like-minded regions. This is another reflection of the resilience, in the Democratic policy circles, of the classical theory of international trade against the resurgence of the mercantilist approach.

A key test at the World Trade Organisation

Donald Trump made the WTO essentially useless by blocking new appointments to its Appellate Body, making it impossible to appeal against decisions by the first-level dispute panel. This paralysed the process since governments could stall the enforcement of the first-level decisions indefinitely.

Biden will be tested very soon on this. Indeed, the WTO has just found in favour of South Korea in the case it brought against the customs duties imposed in 2012 by the US on steel and large power transformers, its first-level panel recommending the tariffs to be lifted. The US has 60 days to appeal to the still in-operational Appellate Body. Biden's administration has two main options: it can stick to the Trump approach and effectively kick the South Korean case into the long grass; or it can unlock the WTO by appealing AND allow the Appellate Body to be replenished, and thus live up to its proclaimed willingness to foster multilateralism. The test is particularly interesting since those tariffs had been put in place by the Obama administration, i.e. when Joe Biden was Vice-President. In addition, as a thorough article in Foreign affairs recently mentioned, the Obama administration blocked the appointment of a South Korean judge to the Appellate Body in 2016 on the grounds that the WTO had repeatedly taken issue with the US trade retaliation framework. There was at least one precedent to the Trumpian attack on trade multilateralism.

It would be in Biden's interest to resolve this issue quickly. Indeed, first-level decisions on the US tariff hikes of the Trump era will probably start coming from the WTO towards the end of his mandate. He would probably prefer to have the "trade issue" resolved by then instead of polluting the next presidential race.

The most appealing course of action may be to offer a comprehensive reform package to the WTO members (in principle the next Ministerial Conference of the WTO meets in June 2021), **unlocking the Appellate Body as a condition to an overhaul of the institution**. Biden could draw on the trilateral statement agreed in 2019 between the US, the European Union and Japan, calling for action at the WTO on *"non market-oriented policies and practices of third countries that lead to severe overcapacity, create unfair competitive conditions for their workers and businesses, hinder the development and use of innovative technologies, and undermine the proper functioning of international trade, including where existing rules are not effective".* Despite all the tension created by the previous US administration, there already is a common basis to work on across traditional allies.

The limits of the US sanction system

The obvious limit to Biden's potential push for a reform of the WTO which would become better aligned with the "interests of the middle-class at home" is that the institution takes its decision by consensus. A push by a club of developed nations to shift the WTO rulebook cannot be successful if China opposes it. The immediate question then is**: what can be the leverage the US and potentially its allies may have over China?**

We were intrigued by Janet Yellen's mention of a "*full array of tools*" against China at her confirmation hearing. This may point to maintaining the tariffs of the Trump era, which Biden has pledged to maintain "for now", pending a review and "in consultation with our allies". But given the new team's dim view of the macroeconomic effect of customs duties, this may also mean that **financial sanctions could be in the frame, expanding on the action already undertaken by the US in the context of the political turmoil in Hong Kong.**

Jeffrey Schott from the Peterson Institute has just released a very timely paper on the scope and effectiveness of the US sanctions framework. He suggests that such approach has been efficient (defined as forcing the target of the sanctions to change its policy in the desired direction) in only 30% of the cases, and usually so only when they applied on relatively small countries, dependent on external capital. More fundamentally, Schott makes a strong point on **the risk for the US to undermine their dominance in global financial markets and the role of their currency as the anchor of the international monetary system if they continue to "weaponize the dollar**". As things stand today, 132 Chinese entities and 114 Chinese individuals are on the US sanction list. However, at this stage, none of the 11 Chinese banks on that ledger are systemic. Going another notch could trigger retaliatory action from Beijing. China has already reduced its investments in US treasuries, but it still is the second highest non-resident holder. Divesting in retaliation to more financial sanctions would trigger a significant loss for Beijing itself, but this threat cannot be completely discarded. Even if China were not to make such dramatic decisions, a growing number of foreign governments and private entities may be tempted to avoid the US market, US financial intermediaries or the US currency altogether. **Sanctions are not a "risk free" alternative to trade war.**

The European dilemma

Biden's team is clearly counting on their capacity to re-build an alliance on trade issues with the EU against China. Brussels has become less and less "naïve" on these matters over the last few years. There as well, the "all out" pursuit of free trade has given way to concerns over employment, inequality and climate change which are very similar to the points made in the Carnegie Foundation report. **The "trilateral" statement expressed European discomfort with that they have increasingly seen as the absence of a level playing field when it comes to dealing with China. But this new assertiveness also applies to the trade relationship with the United States** after the trauma of the trade war which affected some sectors of the European industry.

In very concrete terms, the EU has just given itself a new weapon in its trade policy arsenal: the possibility to impose punitive tariffs when the WTO first-level panel has ruled in favour of the EU, without waiting for the result of the process with the non-operational Appellate Body. This can be read as an "anti-Trump tariff weapon". It's obvious the Europeans are hoping for a re-set with the US under the new President, starting with a final "peace settlement" on the never-ending dispute over subsidies to the aircraft industry, but they are taking no chance and clearly intend to start discussions with the US administration from a position of strength.

A key issue for the Europeans is to decide whether they absolutely need to side with the US on pressuring China into concessions or if they can achieve significant results by talking directly to Beijing. The Comprehensive Agreement on Investment (CAI) signed between by the EU and China in December would suggest that a bilateral approach can yield concrete results. Some of the components of the deal remain "declarative" and quite vague, but EU businesses will however be able to access the Chinese market more easily, with for instance the phasing out of the joint venture obligations in manufacturing, financial and real estate services. Quite importantly in the context of the discussions on the future of the WTO, China agreed to transparency rules on subsidies in the services sector, as well as sets up a rulebook for State-Owned Enterprises (SOEs) which would in principle prevent them from discriminating against European entities, with a dispute resolution process. Forced technology transfers would also disappear.

Of course, the agreement, which still needs to be fully finalized, will have to be scrutinized and endorsed by the European Council and the European Parliament – which could trigger some thorny discussions, notably on the human rights implications. Looking ahead, implementation will of course be closely monitored by the EU, but arguably, the Europeans have in principle obtained in terms of market access in China much more than their American counterparts. **CAI would be a sort of blueprint for the "phase two" deal which remains elusive between China and the US.**

The relationship between the US and the EU runs deep, and despite CAI Biden can still count on quite a few arguments to win the Europeans to a more muscular approach towards China. Europe has little geopolitical conflict with China, but still depends on the US for its security via NATO. Reassurance from Washington DC on protection against Russia and strengthened cooperation in the Middle East and North Africa would bring a welcome change of mood from the Trump era. In addition, the US may be able to count on some divergence within the EU. As can be seen in Exhibits 1 and 2, an improvement in the trade and investment relationship between the EU and China would mostly benefit Germany. Judging by the bilateral balances since China jointed the WTO, France and Italy look quite similar to the US when it comes to the economic relationship with China.

Exhibit 1 – Germany stands out on trade with China…

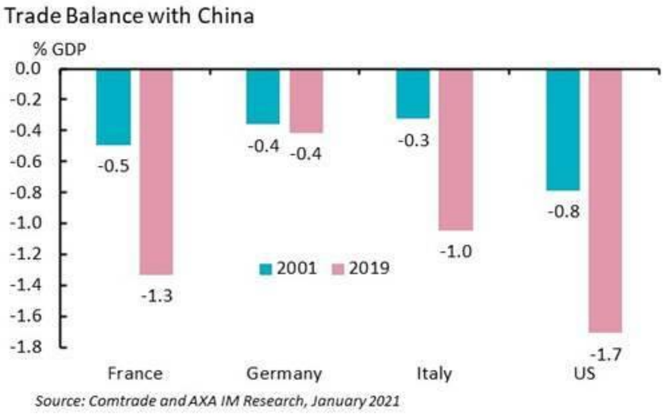
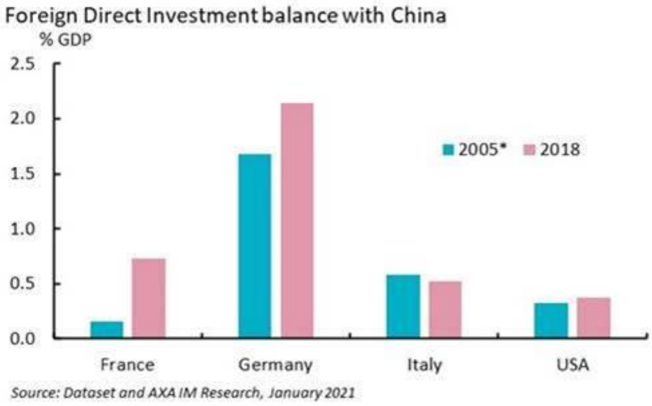


Exhibit 2 - …same with investment



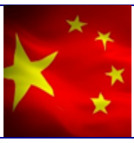
Still, Washington DC will have to expense quite a lot of political capital to create a united front against China on trade issues. **On top of the CAI, China is participating to the brand new Regional Comprehensive Economic Partnership of 15 countries in the Asia Pacific region, including some key allies of the US**, such as Japan, South Korea or Australia. As our colleagues Aidan Yao and Shirley Shen suggested in a recent note, the overall immediate impact of RCEP may be small, since a lot of them already have bilateral free trade agreements, but there was no such deal between Japan and China.

The chances of the cooperative approach and the technology issue

Habitual readers of Macrocast know that breezy optimism is not the main characteristic of your humble servant, but **there might be a cooperative path out of the current predicament**. Of course, CAI is an attempt by Beijing to lure the Europeans away from a close alignment on the US on trade issues, but beyond this geopolitical motive, it probably also reflects a willingness in China to "leverage" greater openness to foreign investment to bring about more innovation domestically, which there, just like everywhere else, will entail challenging some dominant positions, including some held by SOEs. China has probably completed its first manufacturing expansion and now needs to continue moving up the value chain, which can be fostered by importing more technical and managerial know-how. Opening to US companies would be a natural second step after the CAI.

This would of course be a narrow path. Yes, China needs to spur innovation and favour "bottom up" approaches but eroding the power of SOEs and curbing subsidies can challenge social and hence political stability. Human right issues are likely to feature more prominently in the trade debate. But the biggest hurdle probably lies in mutual distrust between Beijing and Washington DC on their relative status on the world stage. The "Thucydides trap", the idea that more often than not, the opposition between an incumbent superpower and an emerging one ends up in open confrontation has become a trope. Still, if we can take the Carnegie Foundation report, with all its subtleties and nuances, as indicative of the new state of mind in the US administration, there might be some willingness to engage in more constructive way with China, especially if US allies can demonstrate that a mutually beneficial economic relationship can be built with this country, and if China itself, for good domestic reasons, chooses to reform its own economy along principles more consistent with the WTO spirit.

The biggest hurdle to this cooperative approach probably is technology leadership, given its importance in security matters and its capacity to shape future dominance. This is where competition between China and the US will remain fierce. This gets us back to our first quote by Janet Yellen. But there might be space for improved trade and investment in more traditional activities.

Country/Region	What we focused on last week	What we will focus on this week
	• POTUS-elect Biden proposes an additional $1.9tn (8.6% GDP) stimulus package • President Biden inaugurated as 46th POTUS, ceremony passed without disruption • Yellen appt hearing, lent wait to stimulus • Senate Republican resistance to $1.9tn stimulus proposal, sets up first battle • Philly Fed index upside surprise • New Covid cases begin to ease • Housing data remained firm	• FOMC meeting, no policy change and no forecasts – Powell to defer taper debate • US GDP Q4 prelim est. We forecast 5.5% (ann) ahead of consensus 4.1%, on exports • Further dip in new cases, roll out of vaccine • Jobless claims to drop back from 900k as seasonals unwind • Personal income (Dec) –show stimulus need
	• Italian PM Conte won a Senate confidence vote but is looking for a larger and more stable parliamentary base • ECB reaffirmed PEPP endogeneity, focus on preserving favourable financing conditions • ECB BLS show further tightening of credit conditions for corporates • German lockdown extended to mid-February	• First Q4 GDP estimates: expect a 3.8%qoq decline in France and broadly flat in Germany (+0.1%qoq) • European Commission surveys and German IFO to reflect intensification of restrictions • AstraZeneca potential approval (Jan 29) key as governments rely on this vaccine from February onwards
	• New virus cases fell to <40k from >60k – easing hospital pressure a few weeks off yet • Retail sales recovered just 0.3% in Dec after -4.1% in Dec, weaker than consensus • CPI inflation rose to 0.6% in Dec from 0.3% • CBI rpt industrial raw material shortage worst since 1970s on Covid and Brexit	• Labour market release, employment to fall further in Nov, jobless still supported by furlough • Further easing in number of new cases • Pace of vaccine rollout – UK delivered 2.08m vaccines in week to 20 Jan
	• The BoJ maintained its current monetary policy framework and kept its forward guidance unchanged. Its GDP outlook has been revised up for FY2021 and FY2022 • December exports increased by 2%yoy • Dec CPI declined by -1.0%yoy (cons: -1.1%)	• Monitoring the spread of the COVID as it may trigger extension of the state of emergency to other prefectures • Dec retail sales and IP have probably been impacted by slower activity while January cons. conf is expected to decline
	• Economy ended 2020 on a high note, with growth accelerating to above trend in Q4 and completing the year at 2.3%	• Daily virus cases stay above 100, mainly concentrated in North China, which may see Beijing impose more restrictions
	• BNM kept the overnight policy rate on hold at 1.75%, and BI also remained unchanged at 3.75%, the Copom maintain the Selic rate at 2% but withdraw forward guidance due to rising inflation forecasts • Korea's 20-day export growth shows a 2021 strong start to 10.6% from 1.2% in Dec. • Singapore's advance print shows that Q4 GDP declined of 3.8%yoy, which is an improvement from -5.6% in Q3	• BCCh and BCC to meet but we don't expect any change on Selic • Brazil IPCA-15 inflation expected to decelerate as supported by lower food prices • Mexico Q4 Preliminary GDP we expect a rebound lower than the 12.1%qoq in Q3 and the new restrictions downside risk could weigh more on Q1 2021

Upcoming events	**US :**	Tue: Conf Board cons conf (Jan), Case-Shiller house price index (Nov); Wed: FOMC announ; Thu: GDP (adv, Q4), Core PCE price index (adv, Q4), Good TB (Dec); Fri: Core PCE price index (Dec)
	Euro Area:	Wed: Fr Insee cons conf (Jan); Thu: Ge HICP (prel., Jan), It ISAT busi & cons conf (Jan), Sp unemp (Q4); Fri: Ge, Fr, Sp GDP (prel., Q4), Ge unemp (Jan), Fr cons spending (Dec), Sp HICP (prel., Jan)
	UK:	Tue: Unemployment (ILO, Nov), Average earnings (Nov), CBI Distriutive Trades survey (Jan)
	Japan:	Wed: Leading index (final, Nov); Thu: Unemployment (Dec); Fri: Consumer confidence (Jan)
	China:	Wed: Industrial profits (Dec)

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