

## **A stalemate in the US–China trade negotiations: the tariff war and technology sanctions**

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The first fortnight of May 2019 saw a major escalation in the Chinese–American trade dispute, in which additional tariffs on around 40% of bilateral trade were imposed and the US introduced an embargo on the Chinese technology company, Huawei. This new phase in the economic conflict between China and the US ends the five month long period of relative de-escalation and intensive negotiations on a framework trade agreement, initiated during the meeting in December 2018 between Donald Trump and Xi Jinping at the G20 summit in Buenos Aires. Unlike during the previous breakdown in the negotiations in May 2018, which resulted in a freeze on contacts, both sides have announced their willingness to continue the dialogue on the trade deal. However, continued escalation of the dispute (for example, over Huawei) is leading to a gradual sharpening of both sides' rhetoric and a toughening of their stances as regards the conditions for recommencing the talks. The present phase of the conflict has revealed deep discrepancies in issues of fundamental importance for the future of the negotiated deal, including the mechanisms for ensuring its enforcement, in addition to the circumstances and dates in which the current punitive tariffs could be lifted. The prolonged stalemate in the negotiations may cause the US to resume its tactic involving a gradual stepping up of its pressure on China, which in turn will translate into a downturn in the global economic situation and Washington's increased political pressure on its allies as regards their cooperation with China.

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### **The stalemate in the talks and the new trade limitations**

On 10 May, the US hiked its tariffs from 10% to 25% on a group of products imported from China, worth around US\$ 200 billion (around 40% of its total imports from China). According to Donald Trump, this move was a reaction to Beijing's sudden withdrawal from certain passages of the draft trade deal that had been under negotiation since December 2018. The US considers these passages of key importance for its interests. The US President claims that the absence of progress in the negotiations may

soon result in a new 25% tariff being imposed on those Chinese goods worth around US\$ 325 billion that have so far not been subject to tariffs. Beijing responded to the US's actions by announcing its plan to impose additional tariffs on American goods worth around US\$ 60 billion (which is around 40% of China's imports from the US) as from 1 June 2019. It has also permitted a minor devaluation of the yuan to occur. According to representatives of American companies, there has been increased administrative pressure on their operations in China (including inspections and prolonged customs procedures).

On 16 May, Donald Trump decided to blacklist the Chinese tech giant Huawei as one of the companies that pose a risk to the US's national security. This decision has resulted in a ban on the sale of American-made components and technology to the Chinese company.

**Unlike punitive tariffs, the ban on the sale of American-made components to Huawei has a significantly more destructive and immediate effect.**

The US President's administration had been considering this move for several months, and its current implementation should be associated with the present breakdown in trade negotiations. Unlike the tariffs intended to reduce the competitiveness of the Chinese industrial sector, the bans on the export of American-made components and technology (which in many sectors are of key importance for the continuity of production activities and the provision of services) have a considerably more destructive and immediate effect: they disrupt bilateral trade and the global supply chains, which is why Trump has rarely used them until now<sup>1</sup>. Some American subcontractors were temporarily (for 90 days) excluded from the embargo on trading with Huawei, which was intended to enable companies from the US and its allied states to plan the related process of reorganisation of their supply chains. Shortly after the US announced its decision, the Chinese side started to send signals regarding the possibility of a potential response in the form of restrictions on the export of the so-called rare earth elements (which are necessary for the production of advanced electronics), whose main producer is China.

<sup>1</sup> One exception involved the introduction in 2018 of a similar three-month-long embargo on ZTE, a Chinese producer of electronic devices. As a result of the embargo, the company experienced a halt in its production activities and decided to sign a settlement with the US government

The intensification of the trade conflict, which has been in place since early May 2019, is happening in the context of the negotiations on a bilateral trade agreement that have been ongoing since December 2018 and are intended to regulate the economic relations between China and the US in a comprehensive manner. After the failure of the talks between Beijing and Washington at the end of 2017 and the beginning of 2018, followed by a series of punitive tariffs imposed by both sides, covering in total around 50% of bilateral trade, Trump suggested to Beijing in December 2018 that the talks should be resumed. The condition formulated by the US was that the agreement should include both a declaration regarding the purchase of American-made products by the Chinese side and a mechanism to resolve long-term problems that are of key importance to Washington, such as trade imbalances, technology theft, China's subsidies for its industries and restrictions on access to the Chinese market. Initially, Trump had set a deadline of three months for the agreement to be negotiated and the absence of any agreement on 1 March 2019 was supposed to result in an increase in tariffs on a group of Chinese products worth US\$ 200 billion from 10% to 25%. Due to the satisfaction both sides expressed with the progress in negotiations, the talks were extended for another two months. The talks resulted in a draft agreement of around 150 pages in length that was briefly presented in the American media. In April 2019, the White House suggested that the negotiations were likely to end soon and would be crowned by Xi Jinping's visit to the US and a meeting with Donald Trump. However, according to the American side, on 3 May the Chinese sent a letter to Washington containing amendments to all seven sections of the draft document and reducing its volume by around 30%. Thus, the tariffs Trump imposed on 10 May were a de facto implementation of the ultimatum he had set for China in December 2018 in Buenos Aires and a further escalation of the dispute by the US is a direct response to China's about-turn in the negotiations.

## The main points of contention

The negotiation stalemate that started at the beginning of May 2019 has revealed major discrepancies as regards the detailed solutions proposed in the future trade deal between China and the US. From Washington's perspective, the trade agreement with China needs to contain, aside from China's commitment to solving key problems, certain mechanisms to guarantee its effective implementation. According to media reports, the US expects an institutional mechanism to be established to monitor the progress of the deal's implementation on an ongoing basis and to provide the ability to impose sanctions (new tariffs) when there is no such progress. Donald Trump is also pushing for the present level of tariffs (covering imports from China worth around US\$ 250 billion) to be maintained until the deal is fully implemented.

**According to Donald Trump, maintaining these tariffs after the deal is signed should guarantee that China will implement the deal.**

The goal is for China to effectively implement the regulations intended, among other things, to guarantee equal opportunities in competition between domestic and foreign companies, open up other sectors of the Chinese economy to foreign investments, eliminate subsidies, and to guarantee that intellectual property rights are respected. At a certain stage of the negotiations, information was leaked to the media suggesting that the US demanded that Beijing should commit itself to refrain from devaluing the yuan (until recently the devaluation of the yuan has enabled China to counteract the negative effects of the US-imposed tariffs). In recent months, the American side announced in the media that there are several boundary conditions to be met before the deal can be

signed, including the demands that the deal should cover all main fields of economic cooperation, that mechanisms for verifying the commitments should be established and that the present tariffs should be maintained for the time being.

Despite introducing its new tariffs in May 2019 and announcing a further escalation of the dispute, Washington initially made several gestures of goodwill, making it possible for Beijing to return to the negotiating table. The tariff increase introduced on 10 May will cover goods that had not yet crossed China's customs border by that day (which will delay the actual introduction of the new tariffs by around three weeks for sea freight). Larry Kudlow, the White House economic advisor, has also announced a likely meeting between Donald Trump and Xi Jinping at the G20 summit in Japan on 28–29 June 2019. There are suggestions from the more conciliatory part of the American administration, as well as in some of Trump's tweets, that this meeting may break the deadlock in the negotiations. However, it may also be a move intended to mitigate the negative repercussions on the financial markets caused by a sudden turn in the negotiations. Opinions have been aired in both within the administration and in the media that the divergences between the two sides are too far-reaching, which is intended to suggest that in the coming months any agreement should be ruled out and that there is a risk of a new period of escalation in the trade war. In his interviews with American media, Trump himself expressed his satisfaction with the current developments in the trade war and announced his intention to step up pressure on Beijing if no progress in the negotiations is made.

The Chinese side has officially denied the US's accusations regarding its alleged breaking of the negotiations and withdrawal from the agreements reached so far, referring to the situation as the emergence of "discrepancies" and suggesting that the two sides should

“meet halfway”. In an interview with the Chinese media, Liu He, the chief Chinese negotiator, mentioned three boundary conditions for the agreement to be signed. First, the signing of the agreement needs to be combined with an immediate lifting of the present punitive tariffs. Second, the US should formulate “realistic” demands as regards the contracts for the purchase of American-made goods and make sure not to change them “at random” during the negotiations. In addition, the Chinese side demands that the content of the agreement should be “balanced” and should not “compromise China’s national sovereignty and dignity”.

**According to Beijing, the conditions formulated by the US resemble the “unequal treaties” of the 19th century and may undermine the stability of the Communist Party’s rule in China.**

The final condition should be interpreted as China’s attempt to limit US demands regarding possible amendments to China’s domestic laws and to reduce the mechanisms intended to guarantee the deal’s implementation. According to Nikkei, when reducing the volume of the draft document at the beginning of May, the Chinese delegation allegedly deleted the passages regarding the legally binding measures for introducing changes, which were thought to have been interpreted as solutions resembling “unequal treaties” forced on China by the colonial states in the 19th century.

The elite of the Communist Party of China that forms the ruling power in Beijing is aware that yielding to such far-reaching demands from the US would significantly limit the CCP’s ability to control the Chinese economy via the sector of state-controlled companies, and also weaken the economic status of the party apparatus it-

self. Moreover, it may slow down the pace of technological development and challenge the rising competitiveness of the Chinese economy. It is difficult to say whether US demands formulated in this way are indeed intended to undermine the economic foundations of the CCP’s rule. What is certain is that this is how Beijing interprets them. It seems that in recent months Beijing has made a series of tactical concessions to create the impression, both in America and in the eyes of the public, that negotiations are nearing their conclusion. At the same time, China was hoping that due to domestic political problems, increased expectations from financial markets and the upcoming electoral campaign, Trump would be ready to sign the agreement at all costs. Despite the failure of this strategy and the US’s retaliatory measures, China has decided not to sever the talks and declares its readiness to continue dialogue (American negotiators have been invited to another round of negotiations that will take place in Beijing). Regardless of this, it has significantly boosted its anti-American rhetoric in state-controlled media. In mid-May 2019, Xi Jinping paid an official visit to the Chinese province of Jiangxi, during which he was accompanied by Liu He, China’s chief trade negotiator, and other figures. During the trip, Xi Jinping visited one of the world’s largest plants for extracting rare earth elements. The speech given by the general secretary of the Communist Party of China contained strong political overtones. In his speech, Xi mentioned the need to “launch another Long March”<sup>2</sup>, which was widely interpreted as China getting prepared for an exhausting and drawn out conflict with the US.

<sup>2</sup> The Long March is a term used to describe the relocation in 1934–1935, over a distance of around 9,000 kilometres, of units of China’s Communist party militia that set off from Jiangxi during the exhausting fight against the government of the nationalist Kuomintang. It is of great symbolic significance for the history of the Communist Party of China and the People’s Republic of China.

## The economic consequences of the new trade limitations

The short-term economic consequences of the present escalation of the tariff war have been mitigated, due to the positive state of the US economy and to Chinese interventions. Following the introduction of the new round of tariffs in May, the main American stock market indices dropped by around 3% (marking the biggest daily falls since the beginning of 2019).

### The escalation of the tariff war is accelerating the process of global companies relocating their production outside China.

However, this happened in the context of evident optimism on financial markets, related to a noticeable growth in the US economy. The tariff increases introduced on 10 and 13 May targeted those sectors that had already been affected by the trade war, which will accelerate the processes ongoing in those sectors that are intended to hit Chinese imports and relocate production to countries other than China. The introduction of a 25% tariff on the remaining portion of imports from China worth US\$ 325 billion may have more serious consequences for the American economy because the goods covered by this tariff include consumer products, electronic devices and clothes. The tariff increases may translate into a hike in inflation and a drop in the purchasing power of American consumers, which in consequence may lead to weaker growth. At present, China's retaliatory measures are mainly targeted at the American agricultural sector, which boosts the political pressure from the sector on the Trump administration and the Republican Party (Trump intends to counteract this by offering subsidies to farmers, for instance).

On the Chinese side, the new round of tariffs caused a temporary drop on its stock markets,

which has been compensated for by interventions carried out by state-controlled investment funds. As a result of the asymmetry in US–China trade relations, China is considerably more affected by the trade war – it has contributed to a slowdown in the Chinese economy that has been ongoing for several months. The Chinese leadership's reaction to the slowdown, including, for example, a drop in private consumption and in retail sales, involves providing temporary stimuli to the economy through monetary and fiscal policy measures. In Q1 2019, this strategy brought relatively positive economic results and boosted Chinese negotiators' self-confidence. However, the debt of Chinese companies, consumers and local governments is growing in an unbalanced manner. This means that by limiting the short-term effects of American economic pressure the Chinese leadership is increasing the cost of any future reforms and delaying the necessary transformation of the Chinese economy.

In the short term, attempts by both sides to disrupt the other side's supply chains will have the most serious consequences for global trade. An example of this is provided by the embargo on the export of American-made components to Huawei. Shortly after President Trump announced his decision to impose the embargo, several companies cancelled their cooperation with Huawei. These included both American and foreign companies such as Google, a supplier of software for smartphones and other mobile devices, in addition to microprocessor manufacturers, e.g. Intel and Qualcomm. Fearing sanctions on the part of the US, several other European and Japanese producers of semi-conductors withdrew from their cooperation with Huawei, including the German company Infineon and the Japanese company Panasonic. The statement by ARM, a British producer of processors (controlled by Japan-based Softbank), announcing the company's intention to cancel its cooperation with Huawei has particularly serious consequences for the Chinese tech

giant. The Kirin processor architecture which is being developed by HiSilicon (Huawei's daughter company) is based on technology solutions and licences granted by ARM. Although Huawei develops its own technologies in software and microchip design, one result of Trump's decision may be a serious disruption of its supply chains, especially in the segment of household electronics and smartphones. This challenges the future development of the tech giant which is of key importance for the competitiveness of the Chinese economy and for Beijing's digital policy. Possible further use of trade blocking tools has been announced by both the American side (an extension of the embargo to include other companies such as Hikvision, a Chinese producer of security systems) and the Chinese side (rare earth elements).

### **The prospect of further escalation**

Although last week there was no formal announcement of the talks between Beijing and Washington, the prospect for reaching a trade agreement and putting an end to the trade dispute has become significantly more distant. It is likely that the two sides will adopt a survival tactic, each hoping that the economic crisis will force its competitor to be the first to make concessions. Beijing may also hope that a potential reshuffle in the US administration will help it to sign a deal on its own terms. This attitude on the part of China is based on a mistaken assumption as regards the mindset of American elites representing the two main political parties, who are beginning to view China as a global competitor. Even if the deal is signed shortly, it should be expected that it will be very difficult for the Chinese side to implement. In the medium term, this will lead to a renewal of the conflict, especially as trade is just one area of competition between the two states.

At present, Donald Trump is determined to continue to step up pressure on Beijing in the

field of trade and to impose new tariffs, regardless of their negative consequences for the economy. His position is being reinforced by upbeat data concerning the American economy (in comparison to the EU and China, for instance), although the US President seems to be making some part of his actions towards China conditional on the mood prevailing on the US financial markets – during periods of stock market downturn a temporary fading of the dispute can be expected. The decision to impose an embargo on Huawei indicates that Trump may repeat the scenario used following the breakdown of the negotiations in 2018. At that time, the US resumed talks only after it had imposed new sanctions that affected the Chinese economy, which was intended to weaken Beijing's negotiating position. However, a quick return to negotiations may be prevented by the upcoming US presidential campaign, in which its relationship with China will likely become one of the main subjects of the electoral campaign. Trump may want to avoid getting entangled in the talks during the campaign, which could otherwise make him dependent on subsequent moves from Beijing.

The introduction by the US of a new round of tariffs in June 2019, and the almost certain retaliatory measures on the part of China, will have a negative impact on global growth prospects and will likely deepen the current slowdown in the eurozone (including in Germany). Unable to offer a symmetrical response to American tariffs (China's imports from the US are more than four times smaller than its exports to the US), Beijing may significantly devalue the yuan, thereby undermining the competitiveness of its trade partners and encouraging other Asian nations to devalue their currencies as well. Continued use of tools to block the export of components may affect European companies that are involved in the trade between the US and China as elements

of global supply chains. Sudden turnabouts in the economic conflict between the world's two largest economies may also destabilise global financial markets and trigger a capital outflow from emerging markets.

Trying to force Beijing to make economic concessions, Washington will likely continue to build pressure in other fields of cooperation, for example, in the military and technology sector. It may also want to press its allies to limit their cooperation with China, both in the bilateral format and within NATO. On the other hand, Beijing will likely continue its policy of offering limited concessions towards the EU, thereby trying to maintain access to the European market and European technology and to

win supporters in its battle with the US by undermining Euro-Atlantic ties. The aggravation of the trade conflict will accelerate the process of a decoupling of the Chinese economy from the American economy and will result in a reorganisation of global value chains, especially in highly developed economies. In the longer run, this represents an opportunity for other regions in Asia and – to some degree – for Central and Eastern Europe to take over a portion of the production activities that multinational companies will withdraw from China. However, the adjustment period and the global economic slowdown that may accompany the whole process have a number of negative ramifications for the global economy.

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