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MACROCOSM

Trump's "Beautiful Monster"

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More than just a phase. The deal is designed to create enough of a boom to re-elect Trump.

It's done at last – a US-China "economic and trade agreement" that President Donald J. Trump described before he signed it as a "beautiful monster of a deal." *We won't know for many months the full extent of the real-economy effects this "monster" will have. We'll get to that in a moment. But the issue here and now is politics, which in this critical election year, is not itself without effects on the real economy* (see "2020 Outlook: After a Near-Miss Recession, It's the Election" January 2, 2020).

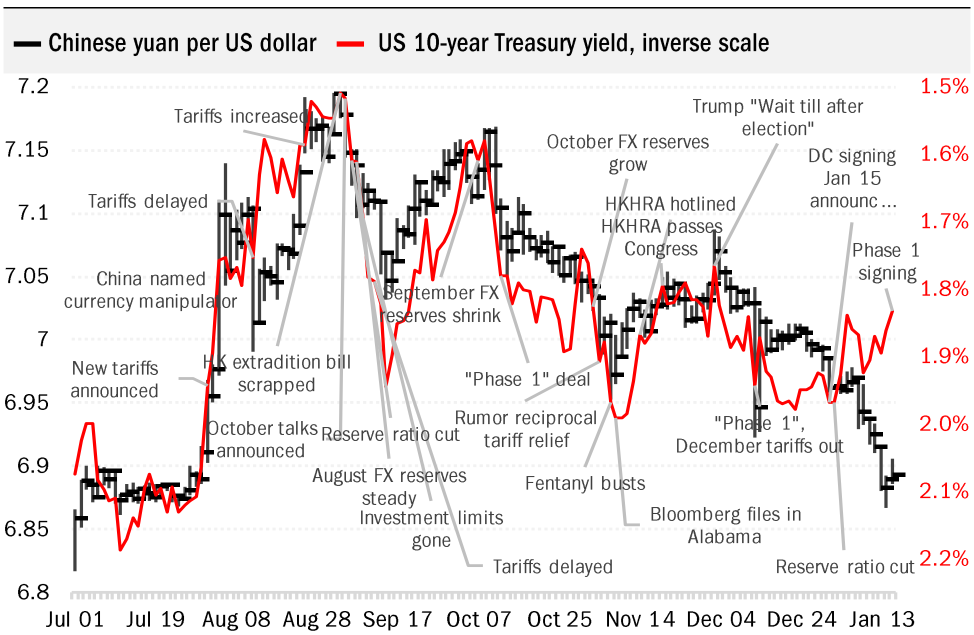
- *Even though the "Phase One" branding persists, the Trump administration is portraying the deal as something more.* The White House press release and the US Trade Representative's high-level fact-sheet both emphasize, first and foremost, the "structural reforms" that China has promised in the agreement, and soft-pedal the previously much-emphasized commitment by China to buy US agricultural and energy products.
- *This positioning is designed to pre-empt criticisms from hawks* in both the Democratic and Republican parties that Trump has "caved" for a mere "hill of beans." We note that thought-leaders among the hawks like Steve Bannon and Kyle Bass were both quite complimentary yesterday.
- China's president-for-life Xi Jinping has his own hard-liners to manage. So he sent a nice congratulatory letter to Trump, but he didn't show up for the White House signing ceremony. There will be no pictures of him "caving" in person.
- *China would have liked more tariff relief in this deal – it got nothing it didn't have already. Perhaps it was supposed to be face-saving for China that the USTR's fact-sheet claims in its first paragraph that "The United States has agreed to modify its Section 301 tariff actions in a significant way." But there's not a single word about that in the actual text of the agreement*.
- Indeed, Trump said at the White House signing ceremony, "I will agree to take those tariffs off if we're able to do phase two, otherwise we don't have any cards to negotiate with. They will all come off as soon as we finish phase two."
- Fair enough. *But those cards are for more than negotiating with – they are for securing enough compliance with yesterday's "Phase One" deal to assure a burst of economic growth sufficient to get Trump re-elected.* That is why the Trump administration decided that the tariffs won't come off until after the November election.

Update to strategic view

US MACRO, ASIA MACRO: The Phase One "economic and trade agreement" with China has been designed to seem comprehensive enough to silence critics who will say Trump "caved," and with enough immediate economic impact to trigger a sufficient boom to assure Trump's re-election. $76.7 billion in additional 2020 purchases by China – from pre-trade war levels – of US agricultural products, energy commodities and products, manufactured goods, and services, could add as much as 0.36% to US GDP, which should be on the upswing anyway because of the elimination of the risk that China will fall into a disorderly recession with global systemic consequences. It's not clear the US can actually produce all China is promising to buy, but Trump's hint he will remove the 2018 tariffs after the election is a strong motivator for China to follow through. China's growth can be enhanced to the extent it complies with promises that will make its economy more free.

[Strategy dashboard]

- China, for its part, has decided that the prudent thing to do is to help Trump get re-elected (see, among others, [“On the Margin: CREEP, the Sequel – China to Re-Elect the President”]() December 23, 2019) – perhaps fearing a worse protectionist in Bernie Sanders (D-VT) or Elizabeth Warren (D-MA), or perhaps betting that playing along with Trump is the surest way to get tariff relief after November.
- Such a China-driven growth burst can only come, between now and the election, from *two aspects of the deal that will have immediate impact*. The “structural reforms,” if they are even real, will take a long time to yield benefits.
- *First*, the deal itself – already, even before it was actually signed yesterday – has *palpably restored confidence that the Chinese economy won’t be sent stumbling into a disorderly first-ever recession* that would have global systemic consequences. Our evidence for this is the strengthening of the Chinese currency, and the corresponding back-up in the US 10-year Treasury yield as the deal has come into focus (please see the chart below). That risk was an element in the near-miss recession of 2018-19, and its elimination is a building block in our argument that 2020 will be a year of recovery (see [“2020 Outlook: After a Near-Miss Recession, It’s the Election”]() January 2, 2020).



Source: Bloomberg, TrendMacro calculations

- *Second*, an increase in Chinese purchases of US agricultural and energy products will be *an immediate boost to US exports. The deal calls for China to increase 2020 purchases by $76.7 billion above 2017 pre-trade war levels* – $32.9 in manufactured goods, $12.5 in agricultural products (including ethanol), $18.5 in energy commodities and products, and $12.8 in services. *The increases will be greater versus the trade war-depressed 2019 levels. So as a first (and too-simple) approximation, that would be a boost to US*

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GDP of about 0.5%. Even if that's only directionally right, *it will feel like a boom.*

- *A skeptic could point out that without a net increase in Chinese demand, these new purchases from the US will come at the expense of reducing purchases from other nations, or from China's domestic producers.* So it would be a zero-sum game, with the US the winner and everyone else the loser.
- *But Chinese demand will expand*. Just as a back-of-the-envelope estimate, if the Chinese economy grows by 8% in nominal terms, that's $960 billion – more than 12 times the $76.7 billion commitment to the US. Even if the reported Chinese growth rate is exaggerated, there's plenty of margin for error. Besides, we think that this year the Chinese government is going to pull every stimulus trick it can think of to assure a good post-deal result (the ruling Communist Party would not wish to first be seen as caving to the US to avoid a recession, and then having a recession anyway).
- The US side is a little trickier. *Without the US expanding its productive capacity, the new Chinese purchases would simply crowd out existing buyers – so the US would experience no growth at all, only higher prices.* It remains to be seen to what extent the US can increase productive capacity to meet this new demand – but it's only a question of extent: directionally, it is certain that this will be a boost to growth.

Now let's take a look at the "structural reforms" in the agreement, separate from the undertakings to buy more US exports. As a reference, click here for the extensive collection of fact-sheets put out yesterday by the US Trade Representative. And click here to review the notorious list of demands the US presented to China in May 2018 when this all began – to our reading, it's amazing how much of it we ended up getting, at least on paper.

We will divide the reforms into two sets. The first set contains *undertakings by China to open up its economy by reducing arbitrary restrictions and regulations pertaining to the operation of foreign firms in China, and the acceptance of imports*. While China may or may not actually follow through on the commitments in this category, at least it is fairly simple and straightforward for it to do so. It requires only regulatory changes with regard to fairly objective matters, not the creation of new institutions designed to handle more ambiguous matters. That means compliance can be immediate, and non-compliance will be easy to detect.

- *Technology transfer* American companies will no longer be required to transfer technology to local partners as a precondition of market access.
- *Financial services* China has agreed to lift foreign equity caps on ownership of financial services firms, clearing the way for wholly US-owned firms to do business on the ground in China.
- *Agriculture* Separate from the matter of China agreeing to certain quantities of agricultural purchases, the agreement also deals with structural barriers to US ag exports to China. These include lifting arbitrary bans on various US meat exports, and reform of so-called

"phyto-sanitary" rules that prohibit certain exports on dubious health-and-safety grounds.

These reforms are non-trivial. If China follows through, it will have significantly opened its economy, both creating opportunities for other nations to do business in China and, at the same time, creating conditions under which Chinese firms will become stronger by learning to compete outside the shelter of protective regulation. No one reviewing this deal should turn up their nose at these reforms – they are substantive.

The second set of reforms are more problematic – more difficult and time-extensive for China to deliver, and operating in realms of ambiguity in which it is difficult to tell whether China has delivered or not.

- *Intellectual property* There are lots of undertakings here, but for critics looking for form-over-substance in the agreement, look no further. The dead giveaway is that the agreement "requires China to promulgate an Action Plan that will outline the structural changes that China will take to implement its obligations under this chapter." *So there is no deal here at all actually – just a deal to make a plan to make a deal.*
- No one should have ever underestimated the technical difficulties of getting China to deliver on IP – even given the best intentions, China would have to develop institutions built around the rule of law and the fair adjudication by the state of disputes under that law. Even if and when such institutions exist, it will be difficult to judge ultimate compliance with the agreement, because many legal disputes involve subtleties of facts and circumstances that are difficult to assess objectively.
- *Currency and macroeconomic policy* This is, in our view, the vaguest and weakest of all the agreement's provisions. For all the fancy words, in essence the agreement is simply that China promises not to manipulate its currency to gain unfair trade advantage. *The problem is that any country with a currency, and a central bank that prints ever-changing quantities of it, is in essence manipulating its currency. We do it. They do it. Everyone does it.*

What about "enforcement mechanisms"? Throughout the US-China trade war, *it has often been said that enforcement would be the greatest sticking point* – particularly from China's point of view, considering that every single provision of the agreement involves some form of concession by China (and none by the US), so the risk of punishment under any enforcement mechanism necessarily falls asymmetrically (and humiliatingly) on China.

- The agreement creates a number of "dispute resolution" mechanisms, including new bilateral forums: a "Trade Framework Group" and a "Bilateral Evaluation and Dispute Resolution Office." Other mechanisms invoke the International Monetary Fund and the World Trade Organization – both of which have been singularly ineffective in dealing with China in the past.

- We have never understood why enforcement mechanisms were so important. *The ultimate enforcement mechanism is the threat of US tariffs, and everybody knows that. That's the mechanism that brought China to the negotiating table in the first place. Indeed, they are so powerful, China has assented to this agreement simply to keep additional tariffs from being imposed*.
- Indeed, the agreement calls for the imposition of tariffs as a remedy for disputes that cannot be successfully resolved – without using the t-word, of course: aggrieved parties may adopt "a remedial measure in a proportionate way that it considers appropriate with the purpose of preventing the escalation of the situation."
- Under the agreement, the ultimate "remedy is to withdraw from this Agreement by providing written notice of withdrawal."
- *In the short term, we think the 2018 tariffs still in force operate as an enforcement mechanism in reverse. That is, China's hope that they will be removed after the election will ensure China's compliance from now till then. After that, we'll just have to see.*

Looking at it overall, we can be as skeptical as we want as to Chinese follow-through and compliance, and as cynical as we want about Trump's and Xi's political calculus. But it remains a baseline fact that yesterday's agreement steps the world back from the brink of China falling into a disorderly first-ever recession. And it remains a baseline fact that, at least directionally, and at least to some extent, this agreement does in fact cause China to reform itself in the direction of economic liberty, which will put it on a higher growth trajectory.

- *We could even go on to say that this agreement incrementally increases the probability that Trump will be re-elected in November. Separate from how any of us may feel about that along any number of dimensions, purely as economic forecasters, we have no doubt that would be the best outcome for US growth and asset prices.*

Altogether, we have both the removal of a significant negative that had been overhanging the global economy, and the introduction of new positives. It's been a long, scary and costly ride to get to this agreement. Let's be realistic about it. But it does point in the direction of goodness.

Bottom line

The Phase One "economic and trade agreement" with China has been designed to seem comprehensive enough to silence critics who will say Trump "caved," and with enough immediate economic impact to trigger a sufficient boom to assure Trump's re-election. $76.7 billion in additional 2020 purchases by China – from pre-trade war levels – of US agricultural products, energy commodities and products, manufactured goods, and services, could add as much as 0.5% to US GDP, which should be on the upswing anyway because of the elimination of the risk that China will fall into a disorderly recession with global systemic consequences. It's not clear the US can actually produce all China is promising to buy, but Trump's hint he will remove the 2018 tariffs after the election is a strong motivator for China to follow through. China's growth can be enhanced to the extent it complies with promises that will make its economy more free.