Trade Deal Delayed, Not Yet Denied

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Any trade negotiator will tell you that the last yard is always the hardest. That is obvious now in the US-China trade talks, which were thrown into doubt by Donald Trump's weekend tweets threatening to hike tariffs on US$200bn of imports from China from 10% to 25% this Friday if a deal is not done.

Most likely, this is just last minute theatrics, designed to placate critics who think the US president is settling for too weak a deal, and to encourage a few final concessions from Beijing. The odds still favor an agreement in time for Trump and Xi Jinping to sign it ahead of the G-20 summit in Osaka on June 28. But the risk that brinksmanship will destroy the deal has risen, perhaps to one in five.

Stronger than expected economic data from both the US and China...

The background for this posturing is that both sides believe themselves to be in a stronger position than they were a few months ago. Since the start of the year, our bet has been that political pressures on Trump and Xi would force a deal. Facing a weaker US economy and a hostile Congress, and with key farm constituencies hurting from China's cessation of agricultural purchases, Trump had to score a win to shore up his 2020 re-election chances. Xi needed to give his ailing economy a boost, and refute internal critics who blamed him for provoking the crisis with the US (see **China And The US Still Hold The Keys To Markets' Fate**).

...have persuaded each side to play tough in the hope of last minute concessioons

In recent weeks, those pressures have eased, while anti-deal pressures have grown. First quarter economic growth in both the US and China beat expectations. Trump weathered the release of the Mueller report, and the Democratic Party clown car has not yet disgorged a credible 2020 challenger. China's revived economy has emboldened its negotiators to resist US demands to cut back industrial subsidies and forced technology transfers. Meanwhile, hardliners in the US—who include not just national security hawks but also labor bosses and Democratic party leaders like Charles Schumer—have amped up their criticism that Trump is not extracting enough concessions from Beijing.

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US nonfarm payrolls rose 236k MoM in Apr, from 179k; avg hrly earnings rose 3.2% YoY	Payrolls higher than 188k expected; wage growth lower than 3.3% expected	Lack of wage-push inflation should allow Fed to keep rates unchanged; positive for equities
US ISM non-manufacturing PMI fell to 55.5 in Apr, from 56.1 in Mar	Lower than 57.0 expected; mainly due to weak employment component	Business activity component ticked up; overall, US growth remains healthy, albeit slower
Eurozone CPI rose 1.7% YoY in Apr, from 1.4% in Mar	Above 1.6% expected; core CPI rose 1.2%, from 0.8%	Jump due to effects of Easter on volatile sectors such as package holidays; core CPI trend still flat
UK composite CPI rose to 50.9 in Apr, from 50.0 in Mar	Above 50.6 expected; services PMI rose to 50.4, from 48.9	Weak outlook for three main sectors: services, construction & mfg; points to slower GDP in 2Q

Chinese markets took a big hit on Monday morning...

The most likely outcome is that a deal will still be done, but it will take a bit longer. The main reason is that global markets have priced in a deal, so a failure of the talks will trigger a massive sell-off. China's leaders know this—indeed, they moved quickly on Monday morning to announce a cut in the reserve requirement ratio for small and medium-sized banks, in what looked like an effort to prop up investor sentiment after onshore stock markets tumbled -5.5%. Nevertheless, since they have already demonstrated their ability to stabilize China's economy through credit growth (see **Stabilization Confirmed**), it is likely they will figure Trump has more to lose in relative terms from a potential breakdown of talks, and so they will be inclined to call the US president's bluff.

...but Beijing will be inclined to call Trump's bluff

Vice-premier and chief negotiator Liu He was scheduled to travel to Washington this week, and there were hopes that the substance of a pact could be wrapped up during his visit. Most likely, China will cancel his trip. Trump will then face a choice: deliver his tariff increase—almost certainly tanking the markets—or find a face-saving way to claim that his threat forced some Chinese movement. There is roughly a four-in-five chance that he chooses a course that leads to a deal a few weeks later, and one-in-five odds that he gambles that looking tough with no deal will serve him better than making the deal.

The US-China trade deal is largely agreed...

Lost amidst all this posturing is the likely content of the deal, which appears to be far more substantive, and more beneficial for US commercial interests, than any agreement with Beijing since China's WTO accession in 2001. About 150 pages of text have been agreed on, and China has apparently agreed to significant market-access openings in a variety of sectors, credibly tougher enforcement of intellectual property rights (in China's interest now that it has its own tech firms' IPR to protect), and protections for foreign investors that have been essentially copied from the bilateral investment treaty that Barack Obama's administration came close to finalizing with China in 2016.

...but there remain three sticking points...

These concessions are incremental, but they are significant (see **Market Access Widens, On China's Terms**). Xi used half of his speech at the Belt and Road Forum in late April to position them as driven by China's own development needs, rather than by US pressure. This showed that Xi was ready to sign the deal, and was building the political rhetoric needed to sell it at home.

There are three main sticking points:

1) It has proved hard to create enforcement mechanisms that will assure the US that China will not renege on its promises, while satisfying Chinese concerns about loss of sovereignty.

2) China has argued for an immediate lifting of all tariffs, while chief US negotiator Robert Lighthizer wants to keep many tariffs in place for a while as a guarantee of Chinese good behavior.

...including Beijing's prized industrial policy

3) China has little interest in agreeing to US demands for fundamental changes in its industrial policies, including subsidies for new industries, a large role for state enterprises, and mechanisms to encourage technology transfer.

Some import tariffs could be retained as a guarantee of China's good faith

The first two problems can be addressed within the deal. The difficulty is that the solutions have enraged hardliners in the US. On tariffs, one way out is for the US to lift the 10% tariffs on US$200bn of Chinese imports imposed last September, but to retain the 25% tariffs on US$50bn of technology goods imposed last July, specifically to target China's tech-transfer practices. On enforcement, China could be allowed to open an enforcement office in its Washington embassy, enabling it to monitor whether the US is offering Chinese firms the same market access that US firms get in China. Since the US is already an open economy, this gesture would be empty, but would give China face.

The rational approach would be for Trump to take the deal on offer

On the deep structural issues, it was always unrealistic to think that China would throw overboard its entire development model in order to secure a quick truce with the US. It is possible to negotiate ways to soften the international impact of these policies, but such talks will take years not months. Rationally, the best approach for the US is to take the deal on offer now, and find other, more patient means to constrain the effect of Chinese industrial policies. But of course rationality and patience are not part of Trump's negotiating style.