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The U.S.–China phase one trade deal

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Almost two years after the start of the U.S.-China trade war, leaders of both countries finally signed the highly anticipated phase one trade deal on January 15, 2020. This is especially significant both politically and symbolically. This deal represents the first time both countries made a move that reduces the tariff rate rather than escalating rates.

In the 88-page deal, China made historic and bold promises in regards to buying U.S. goods and services. China pledges to buy an additional $200 billion worth of U.S. products in 2020 and 2021. In particular, China promises an additional $12.5 and $19.5 billion purchase of U.S. agricultural products in 2020 and 2021, respectively.

If realized, these will lead to the two highest agricultural export watermarks for U.S.-China agricultural trade. However, the commodity markets did not show a significant rally as hoped. Instead it exhibited noticeable drops.

In this article, I share key details of the phase one deal focusing on its agricultural provisions and share my personal opinions and thoughts about the deal and its implications for U.S. and global commodity markets and agricultural exports.

Bold promises

Over the past two decades, China quickly became one of the most important trading partners for the U.S. Today the U.S. averages $22 billion of agricultural exports to China, an almost ten-fold increase from 2001. Production agriculture is not a comparative advantage for China, especially for land-intensive feed grains and proteins such as soybeans and beef. As a result, soybeans, sorghum, distiller grains and other feed grains represent almost 70% of Chinese purchases of U.S. agricultural products 2013–2017, and China is one of the indispensable trading partners of U.S. agriculture (Figure 1, next page).

China's promised additional purchases in the phase one deal, if realized, would make annual agricultural exports from the U.S. to China shoot up from $20–$25 billion a year to around $35 billion in 2020 and more than $40 billion in 2021. These levels have never been seen before but are not necessarily unachievable: Our previous research shows that China's agricultural imports from the U.S. could potentially rise to more than $50 billion a year if China removes all tariff and non-tariff trade barriers. However, the challenge is whether it is realistic to expect China to make all these structural changes over the next two years.

The agricultural commodity market reactions to the phase one deal are very interesting. Rather than offering rallies following the signing of the deal, the soybean and corn futures prices slipped about one percent.

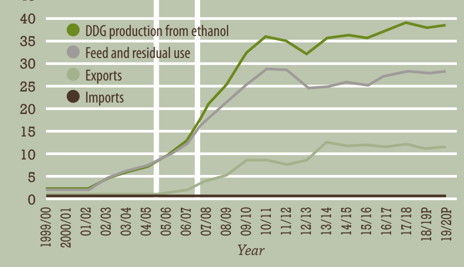
Continued on page 2

Dried distillers grains: Now a key ethanol coproduct

U.S. corn usage is significantly impacted by ethanol production. Producing ethanol yields several coproducts that have become commodities in their own right.

The most significant coproduct are dried distillers grains (DDGs), both in size and value, according to the Economic Research Service (ERS) of the U.S. Department of Agriculture (USDA). DDGs are typically used as a protein-rich animal feed. Roughly 38 million metric tons (MT) are projected to be produced in 2018/19. They also are increasingly being traded internationally. U.S. exports have grown substantially during the past decade.

Dried distillers' grains (DDGs) supply and use has risen in concert with ethanol fuel production



Note: P = projection. 2018/19 and 2019/20 data are projections.
DDG = Dried distillers' grains.

Source: USDA, Economic Research Service Bioenergy Statistics data.

This languish reaction results for three reasons:

First, the agreement did not include concrete details on how the $12.5 and $19.5 additional targets are derived based on commodity-level details.

Second, the agreement has language that sounds like an escape clause for China: "purchases will be made at market prices based on commercial considerations and that market conditions, particularly in the case of agricultural goods, may dictate the timing of purchases within any given year."

Finally, the agreement has unrealistic future promises which further add concerns. In particular, the agreement states that "the trajectory of increases in the amounts of manufactured goods, agricultural goods, energy products, and services purchased and imported into China from the United States will continue in calendar years 2022 through 2025."

In summary, the commodity markets act as if these promises are too good to be true, and it needs more concrete evidence of elevated Chinese purchases.

Figure 1:
Key US agricultural exports by commodity and country in 2017

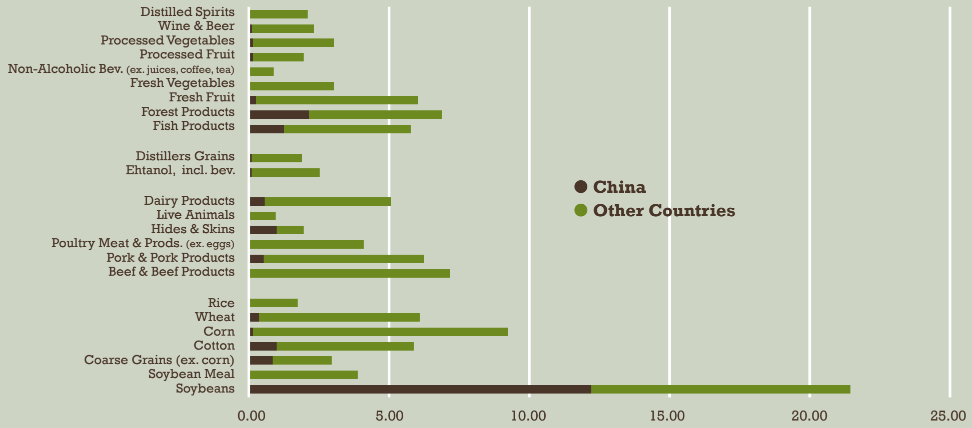
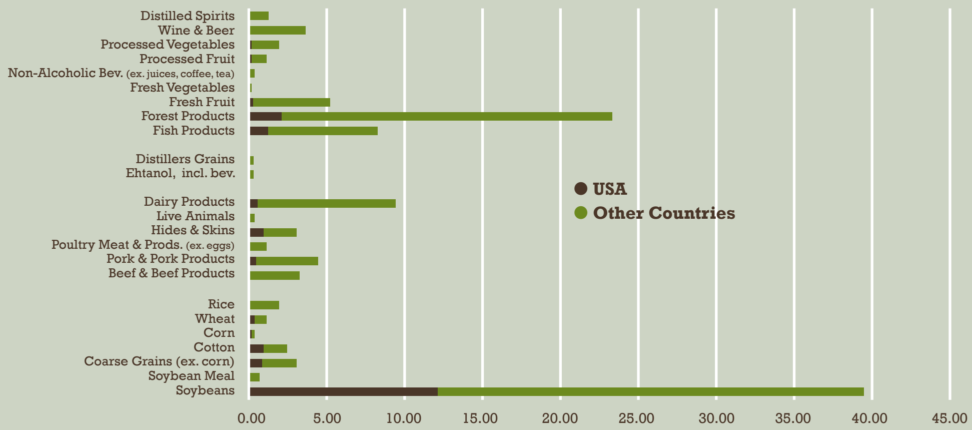


Figure 2:
Key Chinese agricultural imports by commodity and country in 2017



Deliver on purchase promises

As discussed earlier, the current U.S.-China agricultural trade is dominated by feed grains especially soybeans. The phase one deal offers an opportunity for both countries to upgrade to a more balanced portfolio of U.S. agricultural exports to China. It is worth noting that the total Chinese agricultural imports exceeded $140 billion in 2017. The U.S. accounts for very small fractions for China's meat, seafood and consumer-products demand. (Figure 2).

As I argued before, the trade war would offer strategic incentives for China and our competitors to continue diversifying away from U.S. agriculture. Given that the Chinese promises are only for 2020 and 2021 in the phase one deal, it incentivizes Beijing to shift purchases away from other foreign suppliers and to the U.S. to overcome the gaps between current trade volume and the promised levels.

In 2017, China already imported 60% of U.S. soybean exports and 75% of Brazilian soybean exports. As a result, a further expansion of U.S. soybean exports at the expense of Brazil and Argentina for the phase one deal would likely be short-lived, if at all possible.

After all, the African Swine Fever led to a more than 40% reduction in China's hog inventory and a 25% cut in pork production. This weakens the soybean demand as a major source of feed for China's pigs. Actually, I anticipate the U.S. soybean exports to China to drop to a lower level, likely 40%–45% of total U.S. soybean exports, as China strives to find more suppliers.

I anticipate that U.S. livestock producers and producers of consumer-oriented products will benefit most from the phase one deal. The Chinese purchases of U.S. agricultural exports would include more poultry, beef, pork, ethanol, wine, infant formulas, nuts, seafood, fruits and vegetables. In particular, I anticipate $1–$2 billion more exports of poultry, pork or beef products each to China in 2020 in part to satisfy the meat shortage created through ASF.

U.S. ethanol exports to China should increase significantly as well, due to China's 2020 ethanol mandate. However, do not expect all or even major surges to concentrate in the Midwest states.

In fact, California agriculture might benefit more, as China buys potentially $4–$5 billion more consumer products such as nuts, fruits and vegetables, wine, seafood, and dairy products.

I think China should not have problems meeting at least the 2020 target for the agricultural purchases, and the 2021 target could pose more challenges, but that is after the 2020 election when uncertainties grow significantly.

One caution is that trade flows are intertwined. Our trade partners might be worried as a Chinese trade diversion to the U.S. occurs to meet the phase one deal. More U.S. exports of seafood products like fish and lobster could pull Chinese demand away from Russia or Canada. More U.S. pork and beef exports to China will hurt EU and Australia.

More importantly, a significant increase in Chinese demand could push up U.S. commodity prices and price out other partners, especially those with whom we do not have a free trade agreement. A surge in U.S.-China agricultural trade does not necessarily lead to a proportional or net increase in total U.S. agricultural exports.

Promises of barrier removals

From the perspective of U.S. agriculture, the phase one deal is probably the most important trade deal, even though there are phases two and three. These will likely deal with other non-agricultural issues. While the center of the attention is on China's major purchase numbers, the phase one deal also includes several important Chinese promises to remove or ease some of the non-tariff barriers related to agricultural trade. Actually, 44 out of the 88 pages of the agreement were devoted to agricultural sectors, and the bulk of it is on non-tariff barrier issues.

First, China pledges formally to allow imports of U.S. meat and dairy products provided that these products satisfy U.S. food safety and sanitary standards as regulated by USDA and FDA as opposed to Chinese standards.

Second, China once again promises to accelerate the approval of Genetically Modified (GM) varieties for feed grains and fodders, which hopefully result in speedy approvals of several GM-corn and GM-soybean varieties. It is interesting to note that recently China granted approvals of three corn and soybean varieties for domestic Chinese companies.

Third, China promises a more transparent and balanced allocation of the tariff rate quotas imposed for wheat, rice and corn, which is often unused and widely criticized by other countries.

Finally, the agreement reconfirms that China is willing to enhance intellectual property protection and enforcement, and avoid forced technology transfer.

Granted, China made promises in removing structural non-tariff barriers before and didn't fully deliver on them. This phase one deal is the most comprehensive so far and has a higher likelihood of real changes due to its high-stakes public nature. As evidenced by the Chinese ethanol mandate, the Chinese agricultural markets and policies increasingly resemble U.S. and Europe.

It is important to focus more on monitoring and enforcing the structural changes in lowering and removing non-tariff barriers outlined in the deal, as opposed to the pledged purchase numbers since they are just for 2020 and 2021.

It is worth noting that the $200 billion targeted increase largely represents a "managed trade" approach, and the impacts of removing the non-tariff barriers outlined in the phase one deal remains to be seen.

New uncertainties

We have new uncertainties in the implementation of the phase one deal as China battles with a severe global epidemic known as the novel coronavirus. The number of confirmed cases exceeds the total number for the 2003 SARS outbreak, and has spread to at least 25 countries globally.

Unfortunately, this coronavirus adds new uncertainties to the implementation of the phase one deal. Logistically, the spread of this virus has caused an unprecedented shutdown of transport and manufacturing in China until mid to late February, and locked down much of Hubei province.

The coronavirus epidemic likely won't die down until April or May, however, the peak demand season for U.S. soybeans is exactly November to early May as well.

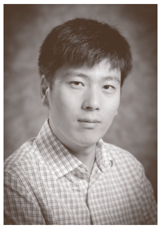
Beyond agriculture, many market analysts worry about the negative impact of the coronavirus on the already-slowing Chinese economy, which likely pushes the GDP growth in China below 6% for the first time in three decades.

The slowing Chinese demand and possibly global demand is not good for U.S. agricultural export market as U.S. agricultural production increasingly rely on international demand.

Conclusion

The highly anticipated U.S.-China Phase One Trade Deal represents a long-awaited relief for U.S. farmers. China made bold promises of an additional $32 billion purchases of U.S. agricultural products over the next two years, however, the commodity markets have been cautious regarding the successful deliveries of these promises.

I think with diversions from other suppliers and dramatic increases of U.S. meat products, ethanol, and consumer-oriented products, China has the capability at least to be compliant with the 2020 target. Given the new challenges posed by the ongoing coronavirus epidemic, the commodity markets are anxiously waiting to see when and whether the promised Chinese purchase sprees are realized.



Dr. Wendong Zhang joined Iowa State as an assistant professor in the Department of Economics in August 2015. His research seeks to better understand the U.S. farmland market, conservation practice adoption, and Chinese agriculture. Dr. Zhang also is affiliated with the Center for Agricultural and Rural Development (CARD). He is the leading researcher of the Iowa Land Value Survey and the Iowa Farmland Ownership and Tenure Survey. Dr. Zhang co-founded the new ISU China Ag center with Dr. Dermot Hayes in collaboration with the Chinese Academy of Agricultural Sciences.

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- **Dried distillers grains (DDGs) now a key ethanol coproduct**