

U.S. Trade Update: China Phase One, FIRRMA Regulations and a Possible Renewal of Multilateralism

January 23, 2020 Edward Lebow, Michael Scanlon

PRACTICES Export Controls and Trade Compliance, Import Relief, Trade and Export Finance, International

With China, the United States has been struggling with how to balance the short-term benefits of continuing business as usual against the long-term risk of becoming too dependent, and eventually falling behind. The increased interdependence of the U.S. and Chinese economies has resulted in lower cost inputs for some U.S. businesses and lower cost products for U.S. consumers, as well as access, although with restrictions, to the one of the world's largest and fastest growing markets. This dependence, however, has come at the cost of wage pressure and lost manufacturing jobs in the United States, as well as with conditions on free speech and foreign policy. In addition, increasing Chinese wealth, which has in part been made possible by exporting to the United States, has permitted Chinese entities to purchase a wide array of U.S. businesses, some of which are in established high-tech fields and others of which are at the forefront of important new and emerging technologies.

Balancing these interests is no easy task. The Obama Administration tried to handle the issue multilaterally, through the World Trade Organization (WTO) and by championing a Trans-Pacific Partnership (TPP), to counter Beijing. The approach of the Trump Administration has been more unilateral, employing tariff increases as a tool to force concessions; at the same time, it has been engaging in wide-ranging talks with Chinese officials.

The route ahead may now be a bit clearer. On January 13, 2020, the Treasury Department made public its final regulations implementing the Foreign Investment Risk Review Modernization Act (FIRRMA), a 2018 law updating the rules administered by the Committee on Foreign Investment in the United States (CFIUS) governing foreign investment in sensitive U.S. industries. On January 15, 2020, the U.S. Trade Representative announced details of the so-called Phase One Deal that begins to address U.S. grievances over imbalances in the trading relationship between the U.S. and China.

The FIRRMA regulations clarify the limitations the U.S. is determined to place on Chinese access to the most advanced levels of U.S. technology and innovation, while the Phase One Deal indicates the Chinese concessions that the U.S. finds sufficient to postpone its next set of tariffs on Chinese imports. Taken together, these two developments suggest where U.S. trade policy toward China is headed, and that in turn may provide some useful guidance to businesses, both in the U.S. and in China.

What the Trade Deal Does and Fails To Do

The Phase One Deal includes a commitment by China to purchase an additional \$200 billion of U.S. goods and services by 2021, relax regulatory practices that impede imports, and protect intellectual property. It also includes a dispute resolution arrangement and a promise that China will not manipulate its currency and will be more transparent regarding its interventions in the currency market. Reception of the deal has been decidedly mixed.

Some point out that many of China's "concessions" are somewhat empty because they should, in practice, aid its economy. For example, in the area of intellectual property protection for pharmaceuticals, U.S. companies have long complained of delays in the issuance of patents in China. This results in a shortening of the effective life of a patent and a reduction in the profitability of branded pharmaceuticals in the Chinese market. The Phase One Deal addresses this with a provision that extends the life of patents in cases where processing exceeds certain specified time limits.

Similarly, U.S. pharmaceutical companies have complained that they have not been afforded any opportunity to raise infringement or data theft challenges to new Chinese drugs before those drugs are released on the market, thus leaving no effective remedy in view of the delays and limited recoveries available from the Chinese judicial system. The Phase One Deal attempts to correct this by establishing a system of judicial or administrative challenges prior to the issuance of a patent similar to the challenges available in the U.S. under the Hatch-Waxman Act.

While nominally being concessions to the United States in the negotiations, these changes may in practice help to ensure a continued or expanded stream of innovative foreign pharmaceuticals in China to serve the needs of its aging population. The stronger patent protection and lengthening of pharmaceutical patent terms may also serve as a stimulant for greater innovation by the domestic Chinese pharmaceutical industry.

Similarly, in the Phase One Deal the U.S. gained market access for its financial services industry (including banks, credit-rating agencies, electronic payment providers, and securities firms) and an agreement by China to make large purchases of U.S. energy products (including significant levels over the pre-trade war baseline of crude oil, refined products, liquefied natural gas, and coal) and tens of billions of dollars of agricultural products in the coming months, far exceeding prior levels. But again, making these concessions and purchases may in some respects help the Chinese Communist Party respond to the needs of domestic Chinese consumers while not threatening vital party interests.

Others note that China has manifestly resisted U.S. pressure for changes in its system of state ownership and state subsidization of state-owned enterprises (SOEs), and, in particular, support for advanced technologies identified in the Made in China 2025 plan. The SOE system is very much at the center of Communist Party ideology and survival. To that end, it also serves as an important lever of central control over local interests. Rather, China has agreed to making improvements in certain sectors of its economy and in certain areas of its governing policy that will simultaneously appeal to U.S. corporations while still serving the interests of the Party.

Thus, while the political leaders of both China and the United States have found it advantageous to announce progress, neither side has been willing to compromise its core national interests, namely state control of the economy in China and protecting innovation in the United States. This situation suggests two realities for the U.S. in 2020. First, for businesses, most of the tariffs on Chinese imports will remain. This includes all of the 25 percent duties on \$250 billion of imports and half of the duties on another \$150 billion (7.5 percent instead of 15 percent). Second, for the U.S. government, new ways will be needed to pressure China to alter its statist trade policies.

Unilateral U.S. Action to Protect its Most Advanced Technology

Under FIRRTA, the initial structure of CFIUS investment review policy remains unchanged; foreign investments resulting in control (more than 10 percent equity ownership) in most U.S. businesses do not require government preclearance. Rather, for transactions involving technology with national

security implications or for businesses with critical infrastructure, an option is available for voluntary submissions to CFIUS to obtain preclearance and thus a safe harbor from any later initiated government review, imposition of conditions, or unwinding of the transaction.

FIRRMA does, however, make filings mandatory, even for non-controlling investments, in businesses that produce, design, test, manufacture, fabricate, or develop products involving certain critical technologies. This is clearly aimed at preventing China from gaining access to U.S. technology that would support its Made in China 2025 plan. A FIRRMA Pilot Program begun in November 2018 identified industries falling within any of 27 North American Industry Classification System (NAICS) Codes as most critical. In response to comments that NAICS codes are overly broad (because they classify business establishments according to similarity in the processes used to produce goods or services), the FIRRMA Regulations have replaced this with a mandatory declaration requirement based upon export control licensing requirements, which when fully implemented will be much more focused.

The FIRRMA regulations also contain detailed guidance as to what types of infrastructure will be deemed critical by CFIUS and what types of investments in companies with sensitive personal data or real estate in proximity to U.S. military or security facilities will be subject to CFIUS review. The U.S. will devote more resources to close scrutiny of foreign investment, as well as provide better guidance about the great majority of foreign investments not requiring CFIUS review. The bottom line: The U.S. wants to remain open for foreign investment as long as core national interests are not threatened.

A Renewed U.S. Appreciation of Multilateral Approaches

Perhaps surprisingly, but quite logically, while much public and press attention has been placed on the bilateral relationship between the U.S. and China, including the Phase One Deal and the new FIRRMA regulations, there have been signs during the past few weeks that the conflict may be becoming more multilateral, as the U.S. quietly reverts to policies that had been followed during the Obama Administration in its pursuit of the TPP.

On January 14, 2020, the day before the U.S. announced the Phase One Deal, the U.S., EU and Japan jointly proposed tightened rules aimed at limiting the advantages state-supported Chinese companies could gain in international markets. Together, the U.S., EU and Japan stated their desire for more stringent global rules to prevent Chinese companies relying on state support from gaining advantage over foreign rivals, including steps to:

- revise the WTO rules to stipulate that a failure to give timely notice of subsidies would result in a presumption that the subsidy causes injury, which would make it far easier for the affected country to seek damages in a much shorter timeframe; and
- introduce a system of escalating administrative sanctions that would reduce the offending member's influence in the WTO and its access to information.

Phil Hogan, EU trade commissioner, said these were “an important step towards addressing some of the fundamental issues distorting global trade.” The EU, he said, “has been arguing consistently that multilateral solutions can be effective in solving these problems.”

These steps, of course, threaten the same core interests that China noticeably protected in the Phase One Deal. Not surprisingly, therefore, Beijing is already pushing back vigorously against U.S. efforts to bring the EU and Japan into its pressure on China. For example, attempts to have Germany join the ban on Huawei components in its telecommunications system have resulted in

China threatening to limit the activities of German carmakers. “If Germany were to make a decision that led to Huawei’s exclusion from the German market, there will be consequences,” Wu Ken, China’s ambassador to Germany warned last month. “The Chinese government will not stand idly by.” Similarly, the Netherlands is facing strong pressure to retreat from its refusal to grant an export license to semi-conductor chip-making machinery producer ASML to sell advanced equipment to China.

Only time will tell if these steps by the Chinese will be effective or, paradoxically, will serve to strengthen European determination that it is time to act. The Trump Administration for its part will have to decide whether its continued weakening of the WTO and persistent threats of trade restrictions on European products – most notably autos – serve its best interests. One would hope to see a deepening recognition that the achievement of national interest can require multilateral cooperation. Achieving that cooperation often involves a careful balancing by each party, and among parties, of competing interests.