



# Can Command and Free Economies Meet?

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## Key Takeaways

- ▶ Given the difficulty of separating trade and ideological issues, investors will want to seriously weigh the prospect of there not being a material U.S.-China trade deal any time soon.
- ▶ The basic impasse is that since the U.S. is a free and open economy, any trade agreement will by definition involve China giving up its controlled command economy, removing the tools China uses to manage not just the economy, but the country itself.
- ▶ The gap may be too wide to bridge with a traditional trade deal. If this is true, it may make winners of some of China's neighbors.

## Differences at the Heart of the Negotiations

From optimism on a deal in April to new tariffs enforced in May, it seems much has changed in the U.S.-China trade dispute in a short time. It's fair to ask, what went wrong? Were they as close as they intimated? I spent last week in China and came away feeling that both sides are entrenched in their points of view and the divide is only widening and hardening. Given the difficulty of separating trade and ideological issues, investors will want to seriously weigh the prospect of there not being a material U.S.-China trade deal any time soon.

## What exactly changed?

Through April there was an illusion of good progress in the negotiations, since what was being discussed was "in-principle" issues. But when it came time to turn principles to actions, bigger problems emerged. To illustrate the point, take equal market access. The U.S. negotiators and legal staff went to work to translate this in-principle issue into actual actions China would have to take, including changing its local laws, agreeing to time limits for doing so, and acknowledging enforcement actions for noncompliance. Hypothetically, this would result in the following directives: China will change its privacy laws by a given date so that global information technology companies can operate freely. Or, by a given date, China will promulgate a new law banning state aid to any corporation or business entity. If China fails to do so, all disputes will be subject to a certain legal arbitration process at a certain international institution.

When they saw the draft agreement, with its translation of the in-principle agreements into actions, Chinese negotiators tried to renegotiate the deal, to move the goal posts, and the whole process collapsed into recriminations.

China's pushback claims the draft agreement impinges on its sovereignty. And in some senses, it is right. Many of the changes go to the very heart of converting a command economy to a free economy. They seek to remove the tools which the Chinese government uses to manage not just the economy, but the country itself. The issues of privacy and national champions illustrate this. They go beyond economics and trade into almost every aspect of Chinese life and governance.

Once you recognize the ideological dimension of the proposed changes, the positions on both sides make sense from their own perspectives. The U.S. correctly points out that since the U.S. is a free and open economy, any trade agreement will by definition involve China giving up and diluting its controlled command economy. China points out that the draft agreement is asymmetric and only involves China making changes. The U.S. acknowledges this but points out the asymmetry in the starting positions of the two countries to justify an asymmetric burden for change on the Chinese side. China complains: why does enforcement have to be a part of the agreement? The U.S. response is that we have spent decades discussing these issues without any progress or changes: enforcements are necessary. Also, what good is an agreement if it cannot be enforced?

Yet China feels robbed of its dignity. The tenor of this position is not surprising, given how quickly the dispute can move away from trade and economic issues into questions of internal politics, global competition among nations and competing fundamental beliefs among peoples. The pervasiveness of these ideological concerns in the dispute suggest that, in some senses, the real issue here is not trade and commerce. These are just manifestations of the more fundamental issue: can a command economy and a free economy do business? These competing beliefs impact everyday lives in much more basic and all-encompassing ways than just tariffs and global trade.

The gap may be too wide to bridge with a traditional trade deal. If this is true, it may make winners of some of China's neighbors. For sophisticated technology manufacturing, investors will want to look at opportunities in Taiwan, South Korea, Thailand and Malaysia. Lower-value add manufacturing may find itself relocating from China to Vietnam, Thailand, Malaysia, India, Bangladesh and the Caribbean.

## Trade is a Multi-Tool

Meanwhile, the U.S.'s use of trade as a negotiating tool to achieve other outcomes looks to be something international investors will have to take into account more and more: India and its intellectual property laws, Japan and its agricultural subsidies and, most recently, Mexico and immigration are all examples of how much the U.S. can try to put on the table in a trade negotiation

### About the Author



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