CORONAVIRUS IMPACT ON THE PHASE ONE DEAL

WHERE DOES IT TAKE THE U.S.-CHINA ENERGY RELATIONS?

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- What does Phase One Deal include?
- How have the U.S.-China Energy Relations changed over time?
- What is the impact of coronavirus on the deal?
- What does the future hold for U.S.-China energy relations?

A BRIEF INTRODUCTION: WHAT DOES THE DEAL INCLUDE?

As Donald Trump came to power, one of the main focal points of his strategy was the relationship between the United States (U.S.) and China. Trump's pledge to revise the relations and tough criticisms against China found bipartisan support in Washington, making it possible for Trump to push further with his strategy which in July 2018 led to an official trade war between both states. Indeed, this is considered to be one of the most difficult times in the last 40 years of American-Sino relations.[1]

The trade war which has been continuing for at least 2 years has negatively impacted the economies of both states. Yet at the end of 2019, the U.S. and China agreed on a truce that would bring the war to a halt. On January 15, 2020, the U.S. President Donald Trump and China's Vice Premier Liu He signed the "Phase One" trade deal between the U.S. and China. As the coronavirus started to shake the world the importance of the deal seemed to fade to some extent; however, as Trump's rhetoric against China, regarding the emergence of virus and the situation in Hong Kong, continues to escalate, the deal will gain importance once more.

The document, entitled "Economic and Trade Agreement between the United States of America and the People's Republic of China," contains eight chapters that cover intellectual property, technology transfer, trade in food and agriculture products, financial services, macroeconomic policies and exchange matters, expanding trade, and bilateral evaluation and dispute resolution.[2]

One of the main issues included in the deal is related to China's pledge to increase the imports of American goods. Accordingly, China would buy an additional $200 billion of goods during the 2020-2021 period, additional relative to a 2017 baseline before the trade war started (Graph 1).

While the deal itself is considered as a very important step undertaken by both states, China's pledge to buy a total of $52.4 billion of energy goods (including LNG,

1. Nahal Toosi and Adam Behsudi, "Virus pushes U.S.-Chinese relationship toward fracture", Politico, (March 18, 2020).

2. "Economic and Trade Agreement between the United States of America and the People's Republic of China", Office of the United States Trade Representative, (Accessed: June 6, 2020).

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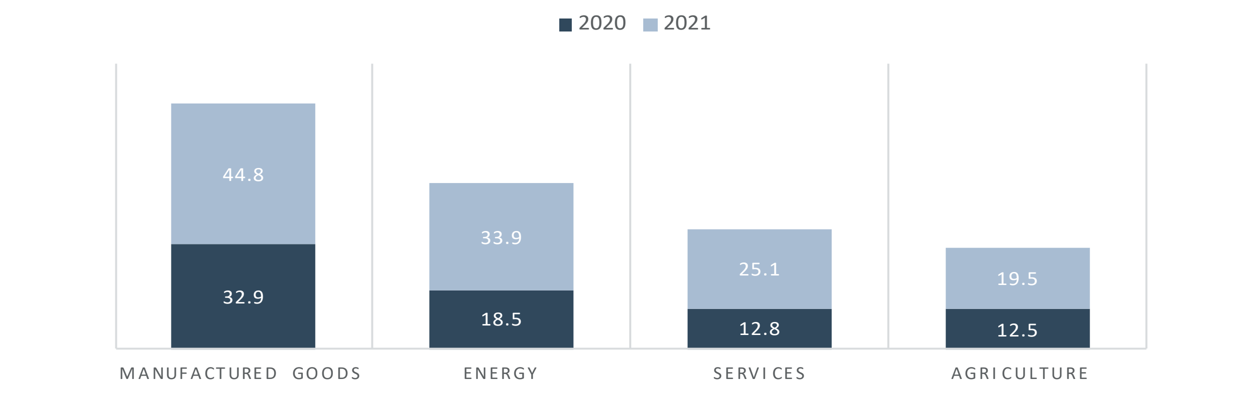
GRAPH 1: PHASE ONE CHINESE IMPORT TARGETS (2020-2021, $ BILLIONS)



Source: Economic and Trade Agreement between the United States of America and the People's Republic of China

TABLE 1: PHASE ONE EXPORT TARGETS ($ BILLIONS)

		2020			2021		
	2017	Increase	Total	Growth over 2017	Increase	Total	Growth over 2017
Manufactured Goods	50.2	32.9	83.1	65%	44.8	95.0	89%
Energy	7.7	18.5	26.2	242%	33.9	41.6	443%
Services	55.5	12.8	68.3	23%	25.1	80.6	45%
Agriculture	20.9	12.5	33.4	60%	19.5	40.4	93%

Source: U.S. Department of Commerce; Phase One Agreement

crude oil, refined products, and coal) is considered as the centerpiece of the deal.[3] With respect to the other sectors, the energy sector is the one with the highest growth when compared to 2017 U.S. exports to China (Table 1).

Since the agreement between the two states was signed, the possibility for China and the U.S. to achieve the set goals was very questionable. The Chinese commitment to buy $52.4 billion of energy goods started to seem an even more impossible target after the novel coronavirus hit the energy sector, especially in China. The country is the world's biggest electricity consumer; however, as the coronavirus started to emerge the industrial production in China fell by 13.5 percent[4] leading to a sharp decline in energy demand.[5]

The coronavirus does not seem to be the only problem for the implementation of the agreement. Under the Phase One Deal China did not pledge to reduce or remove either the 5 percent tariff on U.S. crude oil or the 25 percent tariff on U.S. LNG,[6] which makes the crude oil and LNG price higher when compared to that of other states. Furthermore, there is another problem related to the type of crude oil China's refineries process. More specifically, China's refineries are generally optimized to process heavy, sour crude oil (such as that from the Middle East), while the U.S. produces mainly light sweet crude oil.[7] Lastly, the Chinese side is not the only one that may not keep up with the agreements. Many experts argue that the energy targets are out of reach for the U.S. when consid-

3. Keith Johnson, "Coronavirus Threatens to Blow Up Trump's Energy Trade Deal With China", Foreign Policy, (February 13, 2020).

4. "Industrial Production Operation in April 2020", National Bureau of Statistics of China, (May 18, 2020), http://www.stats.gov.cn/english/PressRelease/202005/t20200518_1745951.html, (Accessed: June 6, 2020)

5. Michal Meidan, "China Day 2020 summary: Geopolitical shifts and China's energy policy priorities", The Oxford Institute for Energy Studies, (March 2020).

6. Even if China's 25% tariff is removed, U.S. LNG would still be about $1.50 to $2.50 per million British Thermal Units (mmBtu) more expensive than other available cargoes. See, Jessica Jaganathan, "Chinese demand for U.S. LNG unlikely to surge as long as tariffs remain", Reuters, (Janaury 16, 2020).

7. Keith Johnson, "Coronavirus Threatens to Blow Up Trump's Energy Trade Deal With China", Foreign Policy, (February 13, 2020).

ering that the U.S. does not have the necessary export infrastructure to accommodate the export.[8]

However, despite these issues, neither side has made any official statement regarding the possibility of terminating the deal. In May, Trump, who sees China as mainly responsible for the coronavirus outbreak and therefore the current global situation, threatened that he would terminate the deal if China failed to meet its obligations.[9] Yet, representatives of both states, later on, announced that "both countries fully expect to meet their obligations under the agreement in a timely manner."[10]

To better understand the impact of the coronavirus on the deal, one needs to look back at the energy relations between the U.S. and China; allowing us to provide a possible scenario on how the bilateral energy trade could evolve in the future.

THE U.S.-CHINA ENERGY RELATIONS

Since its opening to foreign trade and investment, China has been one of the world's fastest-growing economies, hence the world's largest energy consumer. On the other hand, the United States is the world's largest crude oil and natural gas producer. As a result, it is possible to state that they are complementary markets, especially in terms of crude oil and LNG. In this regard, China would be willing to import more from the U.S. and "the distance between the two can be largely overcome with the U.S.' resource abundance and low cost."[11] Indeed, before the trade war started China was considered a key destination for the U.S. energy exports. In 2017, China was the second largest U.S. crude oil importer and the third largest LNG importer.[12] However, compared to the Chinese demands the U.S. exports to China were still quite limited in value and volumes. This went hand to hand with the Chinese policy to avoid becoming too dependent on any single source or any single supplier, as it is aiming to increase its domestic energy security.

As the trade war continued to escalate the bilateral energy relations started to degrade. Since the tit-for-tat tariffs started in July 2018, the U.S. exports of crude oil and petroleum products to China have decreased drastically (Graph 2). More specifically, while the U.S. exported 15,890 thousand barrels to China in July 2018, the exports fell sharply to 4,028 thousand barrels and 1,570 thousand barrels in August and September, respectively.[13] The low export levels have continued since then. Despite the Phase One Deal which was signed in mid-January and implied a significant increase in the crude oil exports and petroleum products, the U.S. exported only 2,389 thousand barrels to China in February, and 7,790 thousand barrels in March.[14]

LNG exports have been affected as well; indeed it can be said that LNG has been hit the hardest as China imposed a tariff of 25 percent on LNG imports from the U.S., in retaliation for the U.S. 25 percent tariff on $200 billion of Chinese imports (Graph 2). Between March 2019 and February 2020, the U.S. did not export any LNG cargoes to China, however in March 2020 17,699 million cubic feet was once more exported.[15]

As the tariffs made it difficult for Chinese companies to buy U.S. LNG, it is not surprising that the Chinese companies started to diversify their LNG

8. Meidan, "China Day 2020 summary: Geopolitical shifts and China's energy policy priorities"; Johnson, "Coronavirus Threatens to Blow Up Trump's Energy Trade Deal With China".

9. Doug Palmer, "Trump threatens to terminate China deal", Politico, (May 4, 2020).

10. "USTR and Treasury Statement on Call With China", Office of the United States Trade Representative, (May 7, 2020).

11. Eric Ng and Amanda Lee, "China needs it, the US has it, but why might a trade war energy deal not be the easy win it appears to be?" South China Morning Post, (May 30, 2019).

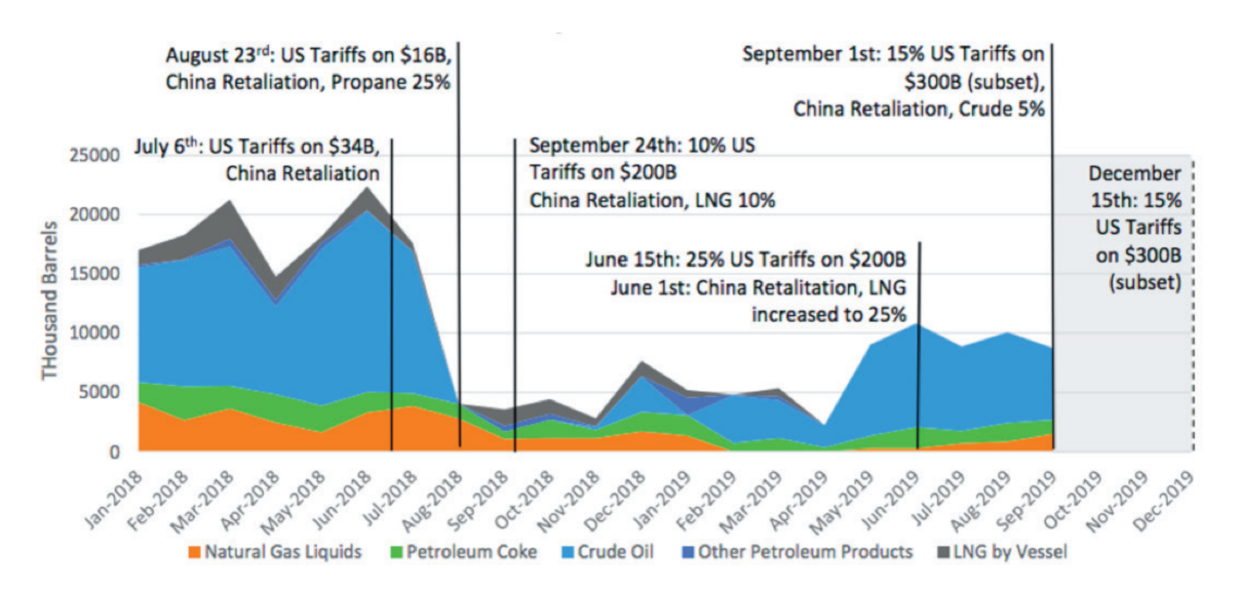
12. "China is a key destination for increasing U.S. energy exports", U.S. Energy Information Administration, (July 10, 2018).

13. "U.S. Exports to China of Crude Oil and Petroleum Products", U.S. Energy Information Administration, https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=MTTEXCH1&f=M, (Accessed: June 8, 2020).

14. "U.S. Exports to China of Crude Oil and Petroleum Products", U.S. Energy Information Administration.

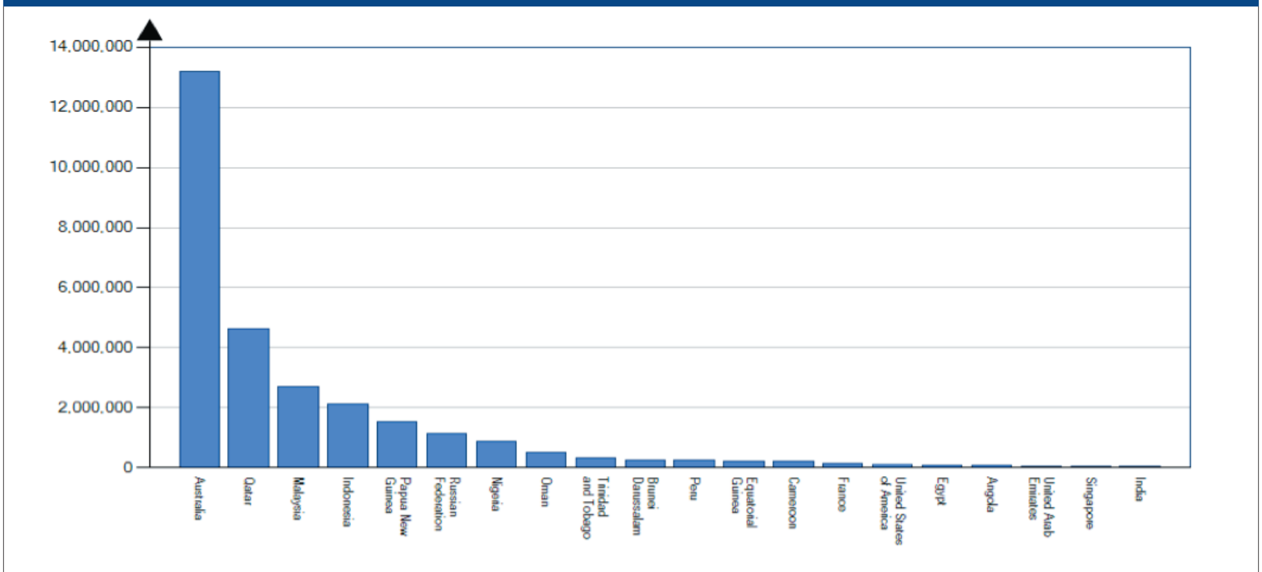
15. "U.S. Liquefied Natural Gas Exports to China", U.S. Energy Information Administration, https://www.eia.gov/dnav/ng/hist/ngm_epg0_eng_nus-nch_mmcfm.htm, (Accessed: June 8, 2020).

GRAPH 2: US EXPORTS TO CHINA



Source: API

GRAPH 3: SUPPLIERS OF LNG TO CHINA, 2019 ($ THOUSAND)



Source: International Trade Center, General Customs Administration of China

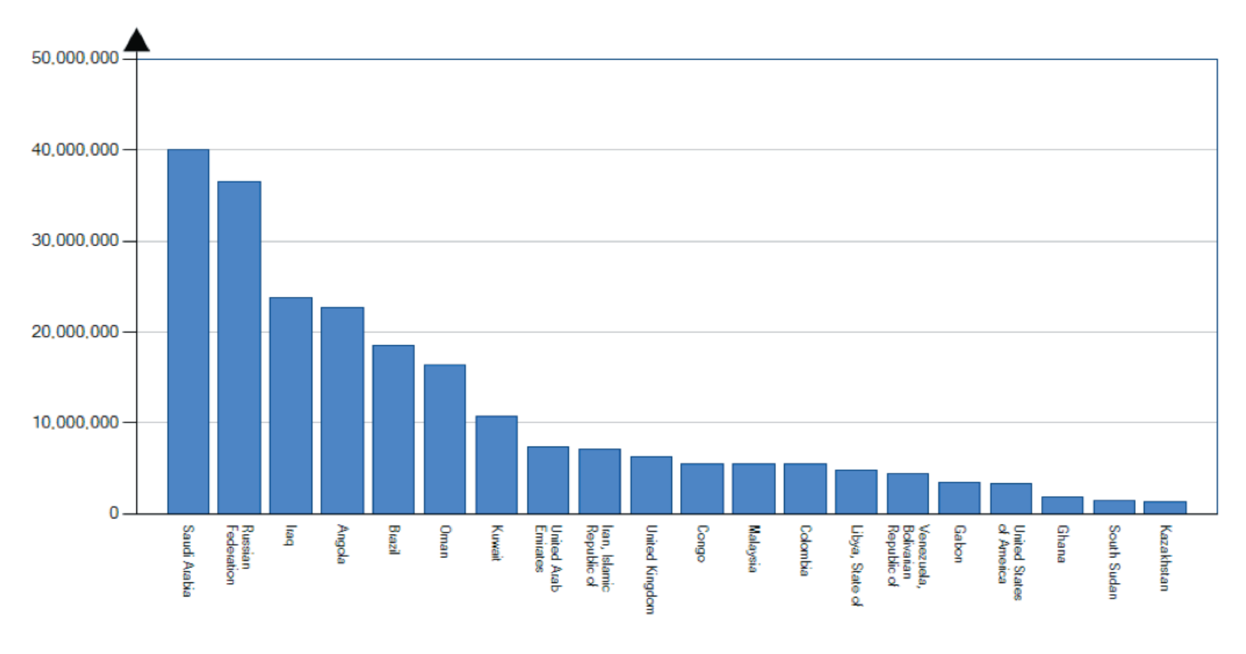
suppliers (Graph 3). In 2019, the U.S. ranked as the 15th country in terms of LNG exports, accounting for only 0.4 percent of China's LNG imports. More specifically, the imports fell from $1.1 million in 2018 to $117 thousand in 2019 (89 percent decrease).[16]

A similar trend is seen in terms of crude oil imports from the U.S. In 2019, the U.S. ranked as the 17th accounting only for 1.39 percent of China's crude oil imports (Graph 4). More specifically, the imports fell from $6.8 billion in 2018 to $3.3 billion in 2019 (51 percent decrease). [17]

16. "Bilateral trade between China and United States of America: Product: 271111 Natural gas, liquefied," International Trade Center, (Accessed: June 9, 2020).

17. "Bilateral trade between China and United States of America: Product: 270900 Petroleum oils and oils obtained from bituminous minerals, crude", International Trade Center, , (Accessed: June 9, 2020).

GRAPH 4: SUPPLIERS OF CRUDE OIL TO CHINA, 2019 ($ THOUSAND)



Source: International Trade Center, General Customs Administration of China

CORONAVIRUS AND PHASE ONE DEAL

As mentioned earlier, the Phase One Deal was signed in mid-January. At that time the impact of the novel coronavirus was not clear yet; however, China's pledge to buy $200 billion of goods and services seemed impossible to achieve. This became even more questionable after China's economy was significantly damaged by the coronavirus. While there is no data about the services sector, in the first quarter of 2020, the U.S. exports to China –manufacturing and energy sector– fell behind when compared to the same period in the previous year (Graph 5).

When focusing on energy, it can be said that this has been the most problematic sector. Based on the latest data, the U.S. energy exports to China in the first quarter of 2020 fell by 33 percent when they were planned to increase by 160 percent; the decrease is higher than the other goods and services that were included in the deal.[18] At this point, the Chinese pledge to buy $52.4 billion of energy goods is highly questionable. At the same time, the U.S. capacity to transport that amount of energy goods to China is in doubt as well considering that many U.S. factories and transportation facilities were closed for a long period. In short, it can be said that the coronavirus made an unrealistic deal impossible.[19]

However, to state that the main reason behind this is the coronavirus, and with it the decline in Chinese energy demands, would be wrong. In the first quarter of 2020, China decreased its imports from the U.S., buying $11.3 billion worth of energy products from Russia and $10.7 billion from Saudi Arabia.[20] A reason for this policy is related mainly to the tariffs imposed by the Chinese government on the American energy goods. Until now, the Chinese government has not indicated that there is a possibility to remove these tariffs.

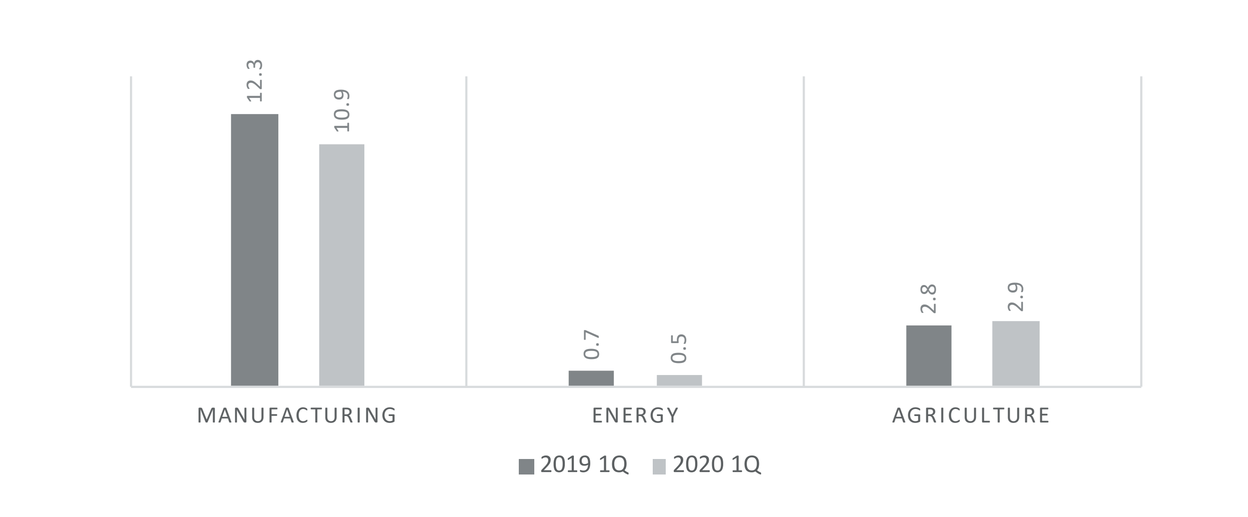
According to some researches, Chinese imports of U.S. energy goods should have been 10 times more than what they are currently in order to meet the goals

18. "U.S. Trade Online", United States Census Bureau, https://usatrade.census.gov/, (Accessed June 9, 2020); Scott Kennedy, "China's Poor Purchasing Performance: How Should the United States Respond?", CSIS, (May 8, 2020).

19. Kennedy, "China's Poor Purchasing Performance."

20. Finbarr Bermingham, "US-China trade negotiators vow to save phase one deal on first call during pandemic", South China Morning Post, (May 8, 2020).

GRAPH 5: U.S. EXPORTS TO CHINA ($ BILLIONS)



Source: U.S. Census Bureau, CSIS

set in the deal. Furthermore, even if China pushes to increase the imports, a maximum of only $13.1 billion would be achievable instead of the $18.5 billion that was planned.[21]

CONCLUSION

The U.S. and China, for a long time now, have been in an open strategic confrontation especially in terms of trade. To halt the trade war that has been on-going in recent years, these two economic giants signed the Phase One Deal. However, as coronavirus emerged damaging world economies, especially the American one, the confrontation between the U.S. and China seems to have been spurred on again and may continue to intensify. On the one hand, we have Trump who is trying to redirect blame for his negligence and mishandling of the coronavirus by holding China responsible for the spread of the virus, and on the other hand, we have the Hong Kong issue which may become the center of conflict in the following weeks.

This brings us to the question: What does the future hold for the Phase One Deal and especially for the U.S.-China energy relations. To answer this several factors need to be taken into account. The November 2020 elections will be one of the main driving factors in terms of U.S.-China relations. Trump's tough rhetoric against China has bipartisan support in Washington and this has gained even more importance at a time when polls show that the anti-China sentiment is increasing especially over the coronavirus.[22] There is a high possibility that Trump will continue with the same rhetoric in order to keep his supporters content and to gain more voters. Yet, for the moment the Trump administration will be reluctant to take any action.

Another factor related to the future of the deal is the Hong-Kong issue. As Trump has stated that he will remove the special status of Hong Kong, the Chinese government has retaliated by ordering the Chinese companies to halt imports of U.S. farm products. Considering that the purchases were crucial for the deal, if the tit-for-tat responses continue, the future of the deal is in great jeopardy.

Lastly, the management of the coronavirus outbreak and its impact on both states' economies plays an important role. If the demand in China increases in the following months, this would make it possible for China to at least come close to the goals set in the deal. However, if the economic development is stag-

21. Sarah Ladislaw, "Energy and the U.S.-China Phase One Trade Deal—Don't Believe the Hype... At Least Not All of It", CSIS, (January 17, 2020).

22. Marc Caputo, "Anti-China sentiment is on the rise", Politico, (May 20, 2020).

nant, then it would be even more difficult for China to reach its goal.

If we were to analyze the future of the deal by considering the above mentioned factors, the first possible option would be the withdrawal from the deal, either for the U.S. or China. However, considering the current economic situation in the U.S. a possible withdrawal from the deal, a possibility brought up by Trump in May, is not expected as it would have a negative impact on an already damaged and fragile economy by creating insecurity in the market. If the trade war reassumes, the market may respond negatively, so hurting Trump's position in the elections. Furthermore, Trump's policy towards China, especially the Phase One Deal, has been one of the strongest points in Trump's campaign. Withdrawing from the deal now would mean accepting that Trump's China policy has been ineffective, and that is not a path Trump would like to follow a couple of months before the elections. Similarly, China is not willing to withdraw from the deal as, similar to the U.S., its market would be negatively impacted. As its economic development slowed down due to the novel coronavirus, restarting the trade war with the U.S. would have a negative outcome.

There is a small possibility that both states may sit again and revise the deal by including more realistic numbers; however, this possibility –until now- has not been favored or requested by either of the states. On the contrary, Chinese and American representatives both vowed to implement their trade deal.[23] Lastly, there is the possibility of keeping on with the agreement. Both states can continue their trade, without reassuming the trade war, and decide what to do by the end of the year. While this seems like the most likely and acceptable scenario, it is important to state that this would just buy some time to both parties as the likelihood that the set export/import goals will be reached is very low.

Whether the deal is cancelled or revised, it would be unrealistic to expect that China would buy $52.4 billion energy goods from the U.S. Even if they did, considering the decline in demand, it would mean that China will have to stop buying crude oil and LNG from the other states and increase its dependency on the U.S., something that is not preferred by the Chinese government. As the U.S.-China relations seem to be in jeopardy, the energy relations are exposed to the risk as well. While for China this would not have a great impact considering that the U.S. is not in its top ten crude oil and LNG importers, the same this cannot be said for the U.S. which is currently looking for possible markets to sell its crude oil and LNG.

23. Yen Nee Lee, "US, China trade negotiators talk about phase one deal as uncertainty looms", CNBS, (May 8, 2020).