Scott Miller: I'm Scott.

Bill Reinsch: I'm Bill.

Scott and Bill: We're the Trade Guys.

Andrew Schwartz: You're listening to The Trade Guys, a podcast produced by CSIS where we talk about trade, in terms that everyone can understand. I'm H. Andrew Schwartz and I'm here with Scott Miller and Bill Reinsch, the CSIS Trade Guys.

Jack Caporal: I'm Jack Caporal filling in for Andrew Schwartz. On this episode of The Trade Guys we'll react to the latest news out of Chile that APEC will be canceled.

Announcer: Breaking news on the Chile APEC Summit next month. This is the summit where Xi Jinping and President Trump was supposed to get together and do a trade deal.

Jack Caporal: What does that mean for trade in the Asia Pacific, and what does it mean for prospects of a US-China trade agreement? Plus, we'll break down two complicated issues. A new bill for Marco Rubio that would impact pension fund investment into China, and new concerns about the complicated auto rules in USMCA. All that and more on this episode of The Trade Guys.

Jack Caporal: We're back with a brand new episode of The Trade Guys. And the breaking news this morning is that Chile has canceled the planned APEC Summit that was going to host in Santiago in the middle of November. And why that matters to the trade picture is because all eyes were on that summit as a place for Trump and Xi to meet and sign the phase one trade agreement that the administration has been touting. And so with no APEC Summit, what's next for the negotiations?

Scott Miller: Well, let's start out with what APEC is. APEC is a group of 21 economies, including both the United States and China. Most are in Southeast Asia, but it's the Asia Pacific Economic Cooperation, as they say, four adjectives in search of a verb or a noun.

Bill Reinsch: A noun.

Scott Miller: In this case.

Bill Reinsch: Forum is the missing noun.

Scott Miller: Forum or whatever. But APEC does have an annual leaders' meeting in the host country. This year the host country is Chile. So it was the item on both President Trump and President Xi's calendar and made for a nice point at which to declare what phase one of the negotiations is, and it was, I thought, a way for the US to show some progress.
The leaders' summit, leaders' meeting has been canceled for reasons of security in Chile. They're having some civil unrest. So Chile made the decision to cancel it. Bill, I don't know if you think it's consequential. I'm not sure it's consequential to the overall negotiation.

Bill Reinsch: It's consequential for APEC.

Scott Miller: Yes.

Bill Reinsch: APEC has turned out over the years to be a surprisingly important organization. Here at CSIS we do an annual pre-summit meeting and the comment made a couple of years that has always intrigued me has been that APEC is strong precisely because it is so weak. It doesn't promulgate rules that everybody has to obey.

Scott Miller: Right.

Bill Reinsch: It produces guidelines and advisory standards. But because it's not mandatory or obligatory on the part of the partners, it allows people to be a little bit more forthcoming in making arrangements. And they've done some very interesting work on privacy, for example, data privacy, which other, the APEC numbers have begun to sign up to and accept, take on one by one responsibilities for.

It's a wonderful organization and it's too bad that it got canceled because they're coming up next year on the 20th anniversary of what are called the Bogor Goals, which were essentially a set of principles designed to produce free trade and investment in the region. And 20 years is the time for stock ticking and setting up new goals. And there was work underway at APEC to do both of those things.

Scott Miller: But there's been a lot of progress in that area, for sure.

Bill Reinsch: Yes. Yeah, it would be a good meeting, and now it's been put off for a year, which is too bad. Unfortunately I think the media is not focusing on that at all, and they're focusing on the chance for Xi and Trump to sign something. And there I don't think it's going to make much difference. It was a convenient action forcing event. They would both be in the same place at the same time.

There are other events if they want to get together. They can both go to the East Asia Summit if they want to, or they can invent a meeting. He can come to Mar-a-lago again, or Trump can go somewhere, or anywhere. There's no ... I mean, it was an artificial meeting, a deadline for that purpose, and there was some doubt being cast as recently as yesterday, which was Tuesday, over whether the agreement would even be ready by that date anyway.

Now, my guess was that if the two presidents wanted to sign something, there would be something to sign. That's usually what happens if
bureaucracies pick up the pace and produce something. But this means it may take a little longer, but there will still be a phase one and at some point there will still be a signing.

Jack Caporal: Do you think this kind of plays into China's hands a little bit if you believe that they're really just trying to wait out the administration, foot drag, and not really commit to any big structural changes?

Bill Reinsch: Well, it probably works to their advantage in that sense. But you can't blame it on them.

Scott Miller: No.

Bill Reinsch: I mean, this was a Chilean decision.

Scott Miller: The pressure's off, but it wasn't, they didn't cancel it, but the Chinese didn't cancel the meeting. It does reduce pressure on the Chinese for specific deliverables.

Jack Caporal: Right. And ...

Bill Reinsch: Can't blame it on Trump either actually.

Scott Miller: No.

Bill Reinsch: For once. It's something that happened in South America.

Scott Miller: Totally, totally-

Jack Caporal: Maybe they can do ... They can do Mar-a-Lago 2.0 and make nice ...


Jack Caporal: Oh, apologies.

Jack Caporal: The other issue, and I think one of the reasons why folks were, some folks were so focused on the potential signing of the phase one agreement is some new data that's come out recently that farm bankruptcies are at their highest rates since 2011. They're up 24% year-on-year. And there's also new data that shows that 40% of farm revenue this year will come from trade aid. That's the trade bail out disaster money, crop insurance, et cetera. And so, we're in a situation now where there's more uncertainty for farmers, et cetera. But you all, you both seem pretty confident that a phase one deal eventually will be reached.

Bill Reinsch: Well, yes. But there remains the question of how much difference is going to make. There was another graph making the rounds that said if they buy 20 billion, that is actually less than what they used to be buying. On the peak
year, I think it was something over 25 billion. One of the great mysteries of this was when they announced it, the word was that they were, the Chinese were going to buy 40 or $50 billion worth of agriculture. Well, if that’s going to be in one year, that’s a big deal and probably impossible.

Scott Miller: But they never specified it.

Bill Reinsch: They never specified the time period. If it’s two years, that’s what they used to do. If it’s three or four years, it’s less than what they used to do. So this is not necessarily a big victory.

Scott Miller: Yeah. Look, the pain in the farm community has been evident for some time. And a couple of the expert guests we’ve had on The Trade Guys, Blake Hurst at the Missouri Farm Bureau and Angela Hoffman of Farmers Free Trade have both talked about there’s five or six straight years of declining farm income and that this is the time we would expect to see bankruptcies begin. And now too through this presidency.

Bill Reinsch: Which is what’s happening. And the political comment has been that in response we’ve been asking people that the great mystery here is that farmers are suffering clearly and they say so. Yet, they’re still supporting Trump. And people keep asking why. And people who know the community and know farmers say, "Well, that will begin to change when they start losing their farms." That farming has historically been cyclical ... Not cyclical, but it has its ups and downs. There are always going to be bad years. This was a bad year for weather-wise, as well as trade-wise. And so farmers over the years have learned you have to go with the flow on this. But when the bank gets their farm and they're dispossessed, that is radical change.

Scott Miller: Right. And it’s always toughest on younger farmers because they have the highest leverage. Farmers who are older tend to own their land, which means they're less exposed to a downturn in terms of the fixed costs of running the place. So it’s doubly difficult for farm communities because you have the general effect of lower, lower prices and lower, lower volume, but then you start to lose the very people you want to keep in the community, which is your young farmers.

Jack Caporal: Right. So have uncertainty on the farmers front and obviously on the goods front with all the tariffs that are floating around here. But now there’s some additional uncertainty on the financial front of the US-China relationship. And this is a story that we’ve talked about before where I think it was a few weeks ago or maybe last month. There were rumors about the administration considering a sort of financial decoupling from China, making it more difficult for US investors to invest in China. Also, there are concerns floating around about the inability for US authorities to audit Chinese companies that trade on US stock exchanges.

It seems like the administration has shelved some of those discussions or at least kicked the can. And because of that, Senator Marco Rubio from Florida
is quite outspoken on China issues. He’s introduced legislation that would block US government pensions from investing in Chinese stocks. Scott, what does that really mean?

Scott Miller: Well, as often happens with our elected officials, the press-release is sort of less than meets the eye. And this is ... Well, what Senator Rubio is proposing restrictions on one of the several funds within the Thrift Savings Plan. The Thrift Savings Plan is essentially the government or federal workers’ 401k plans. Okay, that’s just the name of it. And he has proposed changes to one of several of these letter funds that federal employees and retirees can choose to invest in. What he’s chosen is one that is basically an emerging markets fund. Think of it, if you’re buying a mutual fund asset or a 401k asset and you wanted a mutual fund in the emerging markets, that would be the equivalent of the I Fund.

But what’s missed in the press release, and is very important in this case is, it’s tiny amount of money. So per perspective. Total pension assets for government workers, federal, state, and local is about $4 trillion. That’s total pension assets under management. Through a savings plan, which is one element, federal only, and sort of the ... It’s a contributory element of the federal pension structure. So TSP, all TSP has 560 billion under management. The TSP I Fund is 5% of that. So $30 billion out of 560 billion total TSP, and 4 trillion total government employee pensions, government retiree pension. So ...

Jack Caporal: So if you’re a civil servant, could this bill really worry you?

Scott Miller: Well, nobody’s using this fund. Not nobody, but it is a small allocation of the typical federal contributor, federal participant today. Two thirds of the money is in either government bonds or something that mimics US traded companies like the S&P 500.

Bill Reinsch: I was in the TSP when I was in the government and I eventually took my money out because I got annoyed with them. But they’ve done a good job in recent years of diversifying the options for federal employees. In the beginning there were only two, one that followed a market index, the S&P 500 or some normal index, and another one that was government securities basically. And those were the only two choices. Now there are more choices. So it really does approximate the kind of 401k that a lot of Americans are in.

This particular issue though is not going to go away because what they’re saying or what Rubio is saying is that the fund in question was going to use an index that included Chinese securities. And that’s what he was objecting to. One of the dilemmas this poses, and I went through this in a slightly different context when I was running the National Foreign Trade Council is the pension fund managers have a fiduciary duty, which really is to maximize returns.

Scott Miller: They act in the best interest of the share owner.
Bill Reinsch: They're messengers of the shareholders. When you start injecting non-economic criteria into the decision making process, you are basically forcing them to breach their fiduciary duty. We ran into this when the NFTC, this is a short digression, but it's an interesting story. We sued Illinois because Illinois had passed legislation relating to state pension funds, state fire department and police and teacher fund... pension funds in Illinois, and there was not just one. Every little community had its own fund. But they're all regulated by the state. And they passed legislation at the time that said you couldn't invest in any fund that did business with companies that were doing business in Sudan. It was a human rights thing. Not that different I think from some of Rubio's motivation.

That sounds like a noble thing to do. It passed the legislature. When you looked into it, and this comment is unique to that time and those funds, this is not a general statement, but we discovered that basically there were 29 funds that...29 mutual funds that these pension funds were allowed to invest in by subject to state regulation. And of those 29, there was only one that met the criteria of the statute. And its return was at that time about half of what the average rate of return for the others was.

So basically what the state of Illinois was saying to the teachers and the fire department and the police was, "We're going to make you accept a lower return because we're pursuing this for a human rights objective." One of our complaints was nobody asked the police whether they thought that was a good idea. Now, there may be some who would say, "Sure, I will accept less money because I think this is a moral imperative." My suspicion is there were probably more people who would say, "Enforce your moral imperative a different way. Don't take it out of my pocket."

Scott Miller: That's an important point that's unmentioned in this story because like Illinois, the first question is whose money is it?

Bill Reinsch: Sure.

Scott Miller: The answer is it's TSP plan participants' money. All right? And somebody ought to consult with them.

Bill Reinsch: Not the state's money.

Scott Miller: It's not the state's money. It's not.

Bill Reinsch: Not the Fed's money.

Scott Miller: It's not the Fed's money. Okay? Also, look, it's a trivial allocation, but it's actually, it's actually a pretty good risk management. We don't give investment advice on the show, but finding out that 5%-

Bill Reinsch: Good thing too.
Scott Miller: Yeah, that's a good thing, but finding out only 5% of assets are in the emerging market funds, first sounds very sensible and totally consistent with good diversification practices. So obviously users are making those decisions and at minimum should be consulted. But Bill's absolutely right about the fiduciary obligation on the fund managers in this case.

Jack Caporal: Right. So, just to be clear, Rubio's justification here is, "To ensure that federal retirement savings can never be a source of wealth funding the Chinese Communist Party at the expense of our nation's future prosperity." Agree or disagree it does seem as though this conversation about U.S. financial linkages to China in a variety of aspects, that conversation's not going away anytime soon. So do you think that some of these proposals will gain legs going forward and there will be a type of financial decoupling that we're seeing on the traditional trade side? It seems to me like that opens up a huge can of worms with a lot of unpredictable consequences just because of the leveraging and ...

Scott Miller: Look, it certainly, certainly could get much worse than it is. It's not very bad now. We still have an open investment policy as a nation, and that's good for Americans. In this particular case, I think Senator Rubio should do with his TSP assets whatever he thinks is right. And before he acts on the behalf of others, he ought to consult with the owners.

Bill Reinsch: Let me add though, and you alluded to this Jack when you began, there are other issues on the table here. And it appears that this particular bill may have some legs because I think there's some sympathy for it inside the administration. And it's a regulatory matter. I mean, you don't need to pass a law to do this. The administration can just have the TSP program, not do that-

Scott Miller: Yeah, that's an independent agency that is ...

Jack Caporal: That's what kicked off the legislation. The Federal Retirement Thrift Investment Board was examining this issue and then they kicked the can for two weeks and Rubio got ...

Bill Reinsch: Yeah, they're not doing-

Jack Caporal: ... antsy.

Bill Reinsch: They're not doing what he wants.

Jack Caporal: Yeah.

Bill Reinsch: But they could do what he wants. So it's a relatively simple thing. The thing, what I thought they were going to do, because there's a much longer history and I think better justification was to have the SEC delist the companies that were not compliant with US audit and transparency requirements.
Jack Caporal: Just delisting Chinese companies that trade on the U.S. stock exchange.

Bill Reinsch: Yeah. And this is not a new issue. We've been fighting with the Chinese about this probably for at least 10 years, and it goes back through at least the Obama administration, if not the Bush administration. If you're going to be registered on American stock exchanges ...

Scott Miller: If you want to be listed, you got to follow the rules of listing.

Bill Reinsch: There are rules, and those rules include allowing auditors in to examine the internal papers of the company, and there are transparency requirements. And the Chinese government has maintained consistently that as a matter of sovereignty their companies are required to refuse to let U.S. auditors do that. And this has been the source of negotiation between the two countries for a long time. We have an organization in the United States called the Public Company Accounting Oversight Board, PCAOB charged with this. And they spent a long time negotiating, thought they had worked something out. It turns out I think they really didn't satisfactorily, and patience has kind of run out on this because the Chinese really are outliers to what our normal requirements that all American companies have to meet. I'm kind of waiting for that shoe to drop because it's so obvious.

Scott Miller: And it's, to be clear, not an anti-China mechanism. It is a requirement of anybody who wants access essentially to American capital markets.

Jack Caporal: Sure. And last question on the financial issue. I mean, what ammunition do the Chinese have here? If we were to do something like delist a number of Chinese companies, prohibit civil servants from putting pension plan money into emerging markets like China, how would China respond?

Bill Reinsch: Well on the pension fund, they probably wouldn't notice because it's so small.

Scott Miller: It's trivial, yeah.

Bill Reinsch: If we started delisting companies, including big ones, that they would notice. They might retaliate. I think not through ... They might retaliate by eliminating US financial services activity in China directly, taking away licenses they've granted, things like that.

Scott Miller: Or effecting other reform issues that are already being negotiated otherwise.

Jack Caporal: Sure. Okay. We'll keep watching that one. Now, switching gears, no pun intended, to USMCA and automobiles, there's ...

Scott Miller: Oh that is a pun.

Jack Caporal: Everybody's favorite topic.
Scott Miller: Well done.

Jack Caporal: And this is kind of a complicated story but I think it's an important one. There's reporting this week about USMCA and auto rules of origin and the way that those rules are administered. Rules of origin essentially are rules in a trade agreement that say how much of a product has to be made within the free trade zone or between the free trade parties or the free trade agreement parties in order for that product to qualify for preferential treatment for duty free trade, right? And the auto rules in USMCA are, I would say, extremely complicated, having spent some time looking at that.

Scott Miller: Well, both far more complicated than NAFTA rules.

Jack Caporal: Yes.

Scott Miller: NAFTA rules was a straight 62.5%.

Jack Caporal: Yes.

Scott Miller: Yes.

Jack Caporal: 62.5% of the vehicle ...

Scott Miller: Of NAFTA contact ...

Jack Caporal: Had to be made in Canada, US, or Mexico.

Scott Miller: Correct.

Jack Caporal: Yeah.

Scott Miller: And they've moved to a 75% and added an element called the labor value added to the calculation, which makes the accounting and therefore the compliance challenges much greater.

Jack Caporal: Yeah. And so without going into all of the details, they've added a labor element. They've added different rules for different materials and different parts and different aspects of the vehicle. And then there are different ways for each company to meet those layered requirements essentially, right?

And so there's a provision in the USMCA that lays out a transition period. So auto companies that are having more difficult time meeting the new complicated rules can have basically a phased in period where they can work with USTR to lay out essentially a business plan that will get them to the rule of origin eventually and in the meantime they can continue to trade automobiles within North America duty-free.
And the concern is that the rules, is that really there aren't many transparent rules about how those transition plans would be approved or would work, right? And so what is the implication there?

Scott Miller: Well, let’s … For the rules themselves, I think this is, and we see this a lot in today's world. We were applying sort of 1980s managed trade ideas to the 2019 reality, which in reality is quite different. It's much more complicated. Where anything is made is a lot more complicated today than it was in 1980. And the USMCA rules were known to be more restrictive. It was announced in advance by the auto industry’s think-tank, the Center for Automotive Research that those rules would first make automobiles in North America more expensive for consumers, and second, they would make U.S. produced automobiles less competitive in export markets. This was known during the negotiation.

Bill Reinsch: Same thing our study concluded, yes.

Scott Miller: Which is actually sort of common knowledge. There is an additional issue that I think is making this even more complicated, which is companies in order to qualify for the preferences you mentioned, which is 2.5% on cars, 25% on trucks, so that, to qualify for that preference you have to have a compliance structure in place and be able to demonstrate that your product complies with the rules.

Scott Miller: Now, in let’s say 30 years ago when NAFTA was being negotiated and being considered in the auto rule, then that time 62.5% was being considered. All the automakers that are assemblers in North America had large compliance staffs in-house, large organizations and there was a lot of work done. This is not a trivial task. One of the things that’s happened though as services delivery has changed and the companies themselves, the assemblers themselves have changed, is very few companies, even large ones, have compliance staff in-house anymore.

Scott Miller: So you’re moving to a more complicated rule, one that requires fairly delicate and sophisticated calculations on labor value added, which is not easy to do in the first place and there’s no habits and there are no regulations to point two of how we’ve done it in the past. You can’t even create a decent safe harbor for the compliance people. Plus, those compliance people are no longer company employees and are in some removed remote facility as a contractor or supplier to the assembler. So this is really ... It’s a nontrivial task. I have no idea how people are going to do it. We’ve often talked on the show, how much do you actually put up with for a 2.5% preference. And that’s the question I hope somebody is thinking about, but maybe nobody is.

Bill Reinsch: And the story that you alluded to in the beginning that came out today suggests that the government is proposing language that would give them very intrusive authority to tell companies where to build and I guess what to
build, which is, I mean it's very odd for Republican administration. I mean, it's classic industrial policy.

Scott Miller: Yes.

Bill Reinsch: I mean it comes close to in some ways nationalizing the industry. I can't believe they're going to be able to sell this to the Congress. But we'll see. It also raises the question of one of the things that I keep running into. When you mess with the market, odd things happen. Why USTR knows more about how the auto industry should be constructed than they do baffles me.

Scott Miller: Yeah. And I've been thinking about this in the context of say, 20 years of trade negotiations. I cannot imagine any U.S. negotiator even giving a minutes notice to some other country who tabled a proposal like this about putting those kinds of burdens on our manufacturers. We wouldn't tolerate it for a second.

Jack Caporal: Sure.

Scott Miller: And yet we're doing it to our own manufacturers that I'm just, I'm confused about why they think this is a better way to do it. At first, I was, at least they seem to agree that they don't have the statutory authority to do it now because they're seeking that authority in the implementing bill for USMCA, but this looks messy, and I think what it'll do is ultimately people would just pay the tariff, build the car the way they want to build it and life goes on.

Jack Caporal: Yeah. It would be very odd for the Mexican government, for example, to tell a company like GM that they have to build another engine plant in Mexico in order for them to qualify for rule of

Scott Miller: Or have to. The transition plans are subject to approval by the government.

Jack Caporal: Yeah.

Scott Miller: That's crazy.

Jack Caporal: People would be setting their hair on fire over something like that.

Scott Miller: It's a preference.

Jack Caporal: But here it's ...

Scott Miller: It's an incentive. You either do what it takes to qualify for the incentive or you don't.

Jack Caporal: Right. Well, I think the issue is that it should be black and white. As you said, you either qualify or you don't. And now there is a level of subjectivity shall we say, that folks are becoming very wary about.
Scott Miller: Yes, we should get the Nobel Prize to whoever, the compliance person who actually figures out how to manage these rules in the first place. It's going to be a heroic task.

Jack Caporal: Indeed. So we'll stay tuned on that and obviously more to come on the next episode.

Bill Reinsch: Always more to come.

Andrew Schwartz: To our listeners. If you have a question for The Trade Guys, write us at tradeguys@csis.org. That's tradeguys@csis.org. We'll read some of your emails and have The Trade Guys react to it.

Andrew Schwartz: We're also now on Spotify, so you can find us there when you're listening to The Rolling Stones or you're listening to Tom Petty or whatever you're listening to. Thank you, Trade Guys.

Bill Reinsch: Thank you.

Scott Miller: Thanks, Andrew.

Andrew Schwartz: You've been listening to The Trade Guys, a CSIS podcast.

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