February 6, 2019

China-U.S. trade deal or not, tensions will remain

By Angelo Katsoras

Both China and the United States have good reasons to want to strike a trade deal by March 1 or, at the very least, agree to extend negotiations. However, it is important to note that, while the markets would breathe a sigh of relief in the short term, a deal in itself would not change the long-term fundamentals fuelling the tensions between the two countries.

Whether an agreement is reached or not, both countries want to become less economically reliant on the other. Consequently, on the one hand, China will keep seeking to take market shares away from American and western companies in strategic sectors like IT, and, in the process, try to become less vulnerable to U.S. threats of banning sales of American-made components to certain Chinese companies. On the other hand, the United States will keep seeking to tighten restrictions on Chinese investment in U.S. companies and respond more vigorously to alleged corporate espionage by China.

Working in favour of deal is the growing vulnerability of both presidents at home

U.S. President Donald Trump kicks off a tough presidential re-election campaign for 2020 with low approval ratings, a stinging defeat in the November midterm elections that gave Democrats control of the House of Representatives, and the perception he lost the government shutdown showdown with the Democrats. Moreover, financial markets have been volatile, and another significant decline would put Trump even more on the defensive.

Chinese President Xi Jinping, for his part, may not have to worry about elections, but public opinion, particularly among the elites, still weighs heavily on his decisions. China's economy expanded 6.6% in 2018, its weakest annual performance since 1990 according to official government data. However, many analysts are skeptical about the accuracy of government figures and suggest growth could be significantly lower in reality.

In short, both sides need a win.

The devil is in the details however

Even more important than merely getting China to buy more U.S. products in order to redress the problem of the trade balance, the long-term success of any deal hinges on whether the United States is satisfied that China will no longer steal intellectual property and force American companies to share their technology as a condition to gaining access to the Chinese market. In this regard, Beijing is reportedly considering a law that would prohibit Chinese officials from demanding that foreign companies transfer their technology to Chinese businesses via licensing agreements or joint ventures.

From the U.S. perspective the challenge is twofold. First, the pressure that U.S. companies face to share their intellectual property often comes from behind the scenes rather than through codified legal requirements. Second, the United States wants the agreement to include provisions to ensure that China honours its commitments. However, China will probably not agree to have the United States be the judge of whether it is complying.

Consequently, even if a deal is signed soon, it is quite possible that several months down the road each side will accuse the other of non-compliance. This would result in renewed threats of tariffs and investment restrictions.

Why Chinese-U.S. trade tensions likely to outlast Trump

In the midst of the partisan political warfare that has consumed Washington, D.C., an unprecedented consensus has emerged against China. Congress (both Republicans and Democrats), the Pentagon, the State Department, the intelligence agencies, organized labour and large portions of the business community all feel that a tougher stance needs to be taken against Chinese trade practices.

"China is believed to be responsible for 50% to 80% of cross-border intellectual property theft worldwide, and over 90% of cyber-enabled economic espionage in the United States," said recently Chuck Grassley, Chairman of the Senate Judiciary Committee.

Last year, the Congress passed the Foreign Investment Risk Review Modernization Act and the Export Control Reform Act into law with overwhelming bipartisan support. Their purpose is to make it harder for Chinese companies to gain access to U.S. technology. Whether a deal is signed or not, these laws will not be undone.

It is important to note, also, that today's trade tensions with China are very different from past commercial disputes the United States has had with many other countries. Historically, the United States has, up to a certain point, tolerated large trade deficits with Germany, Japan, and South Korea because they are close allies and democratic states. In stark contrast, China is increasingly viewed as an authoritarian geopolitical rival intent on reducing America's global geopolitical and economic influence. **It is also a competition between two very different economic and political models: one market-oriented, the other increasingly state-driven and authoritarian. This has widened the philosophical divide between the governing elites of each country.**

The development of two distinct IT markets

Deal or no deal, certain U.S. tech companies will likely continue to have a hard time entering the Chinese market, and Chinese tech companies will likely find it increasingly difficult to access not only the U.S. market but to a lesser extent other western markets as well. In this regard, the United States has been surprisingly successful to date in persuading its allies to ban Huawei, the Chinese telecommunications equipment manufacturer, from their future wireless network infrastructure or at least to severely restrict its presence within them. **This suggests that China has underestimated two key factors: 1) the concern among western countries that its technology could be used for spying; and 2) the long simmering resentment against its restrictive trade policies.**

Below are some of the western countries that have either banned or are considering restricting Huawei components from their 5G networks.

- The White House is reportedly drafting an executive order that would effectively ban U.S. companies from using Chinese-origin equipment in critical telecommunications networks. This would go far beyond existing rules, which ban such equipment only from government networks, even though one could argue that Huawei has been effectively banned from the U.S. market since a 2012 Congressional report raised concerns that its equipment could be used for spying.
- While Canada reviews the security of its telecom supply chains, it is feeling the heat from both sides. On the one hand, it is facing pressure from the United States to bar Huawei technology from its 5G network infrastructure. On the other, China has publicly threatened reprisals if Canada does implement a ban. While the decision on Huawei is likely a few months away, the strong possibility of restrictions being implemented in the near future combined with America's de facto ban means Canada's largest wireless service providers are probably already shopping for new equipment suppliers. **Certain of them could decide to lobby the federal government for financial aid to help offset the costs of pulling out existing equipment in favour of new suppliers due to what they say are geopolitical forces beyond their control.**
- Australia and New Zealand have blocked Huawei from building fifth-generation (5G) networks.
- Britain is considering banning Huawei from supplying parts for its future 5G network. UK-based Mobile carrier BT has already announced it is removing Huawei equipment from its network. Meanwhile, Vodafone Group, which is also based in London, said it would temporarily stop buying Huawei equipment for core parts of its next-generation wireless networks while European governments consider whether to ban or restrict the use of Huawei components.
- The German government, too, is considering restricting Huawei equipment in the country's next-generation mobile networks. Last December, Deutsche Telekom AG, the Bonn-based telecom provider, said it would review its equipment procurement strategy. Further, Germany has approved rules subjecting any non-European foreign company attempting to buy more than 10% of a German company involved in defence, technology or media to a much more stringent approval process.[1] It is widely thought that the new rules are aimed squarely at China.
- France, also, is examining whether it should place restrictions on Huawei. Orange, a mobile telecommunication services provider, has already announced it would not use Huawei equipment to build its next-generation network in France.
- Polish authorities recently announced that they had detained a Huawei employee and charged him with spying on behalf of China. The Polish government is also reportedly considering excluding Huawei from bidding on its 5G networks.
- The Japanese government announced in December that it would ban Huawei and ZTE from government contracts. This was soon followed by Japanese media reports that Japan's three big telecom operators, NTT Docomo, KDDI and SoftBank, also planned to follow the government's lead by not using equipment from the two Chinese companies in their current networks and in their upcoming 5G upgrade.[2]

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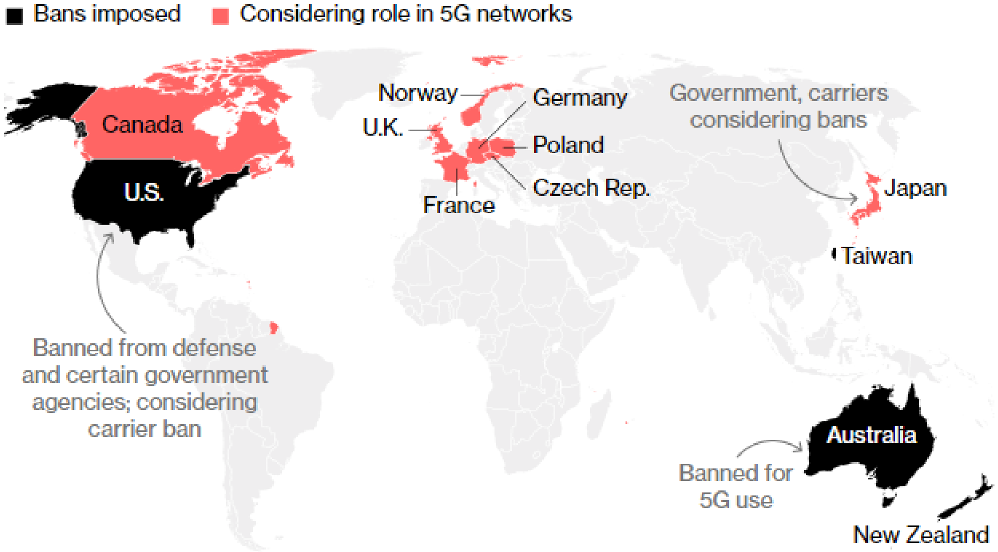
[1] "Germany Tightens Foreign Acquisition Rules Amid China's Push for Technology Deals," Wall Street Journal, December 16, 2018
[2] "Japan effectively bans China's Huawei and ZTE from government contracts, joining U.S.," Washington Post, December 10, 2018

Huawei Under Fire

Governments are barring equipment-maker from mobile rollouts



Sources: Bloomberg reporting, local media

Source: "U.K. DoublesDown on Criticism of Huawei's Flawed Systems," Bloomberg, January 17, 2019

While being squeezed out of western markets is a significant setback for Huawei, it can still rely on its huge home market, much of Asia, and other developing world regions. In this regard, many smaller Asian countries are afraid of imposing restrictions on Huawei's 5G mobile network equipment because they enjoy strong trade ties with China. Also, the lower cost of Huawei equipment confers a competitive advantage in much of the developing world. The United States simply does not have the leverage to pressure many of these countries to bar or significantly restrict Huawei equipment.

The United States and China have seemingly irreconcilable views when its comes to the IT sector

The U.S. government argues that there is a major difference between spying for national security purposes, which the United States admits to doing, and the commercial espionage it claims is carried out by China's government. The Chinese feel that this differentiation is little more than a ploy by the United States to maintain the commercial advantage of its companies for as long as possible. China's suspicions were further reinforced by the published leaks of Edward J. Snowden, the former National Security Agency contractor, in the summer of 2013 that revealed the full extent of U.S. espionage capabilities. As for the United States, it feels China wants to have it both ways: block U.S. companies such as Google, Facebook and Microsoft for its market, while demanding full accessing for its IT companies to the U.S. market.

Conclusion

Even if a trade deal is signed, both sides will continue to at least partially undo some of the economic integration that followed China's accession to the World Trade Organization in 2001. **Going forward, we will likely see a more transactional relationship develop between the United States and China where decisions on whether to do business and/or to allow investment will be made on a case-by-case basis.**

In addition to assessing which companies have the best products/services, the new geopolitical landscape will increasingly require investors to analyze whether the supply chain and business models of companies in strategic sectors are compatible with the geopolitical objectives of either China or the United States. **Companies that choose to focus on the U.S. market risk seeing their access to the Chinese market reduced, while companies opting to focus on the Chinese market could find it harder to gain market share in the United States. Over the long term, companies may also be forced to set up two supply chains, one with access to the United States, the other with access to China.**

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