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Is Great Power Rivalry Reshaping Canada's Economic Landscape?

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Canada and its businesses will have to adapt to a global environment shaped more and more by long-term tensions between China and the United States. This includes dealing with the emergence of two economic models, living with a heightened risk of becoming collateral damage, and having geopolitical objectives increasingly overshadow economic ones. This report lists and analyzes these and other challenges.

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

While a trade deal between China and the United States would be good news for the markets in the short term, it would not change the long-term fundamentals fuelling tensions between the two countries. This includes the battle for geopolitical influence and dominance of tomorrow's technologies.

This dynamic is reinforced by a healthy dose of mutual distrust. On the one hand, the United States suspects that China's ultimate aim is to steal U.S. technology and to replace the United States as Asia's preeminent geopolitical power. On the other hand, China feels that the United States is seeking not only to gain greater access to the Chinese market but also to constrain China's rise as a global power. Both views have some basis in truth.

The recent breakdown in trade talks further exposes the divide between these duelling narratives. China sees U.S. demands that it change its laws and agree to intrusive monitoring as an infringement of its sovereignty, while the United States sees China's refusal to specify in writing how it will amend its laws as an indication that China is not intending to keep its promises. A 2018 report by the Office of the U.S. Trade Representative found that China had falsely promised eight times since 2010 to not force foreign companies to transfer technology to their Chinese counterparts.[1]

This gap is further widened by the unprecedented consensus that has emerged against China in the United States. Both political parties, the Pentagon, the State Department, the intelligence agencies, organized labour and large parts of the business community all feel that a tougher stance needs to be taken against Chinese trade practices. **The change in tone coming from much of the business community is particularly noteworthy because, historically, it has been one of the staunchest opponents of tariffs against China. Myron Brilliant, head of international affairs at the U.S. Chamber of Commerce, recently described China's trade policies as "a threat to our economy, to our competitiveness and to our global trading system".**

Even if an agreement is reached, both countries will continue to strive to become less economically dependent on the other. China will continue in its efforts to take market shares away from American companies in strategic sectors and, in the process, try to reduce its vulnerability to bans on the purchase of U.S. technology. As for the United States, it will continue to tighten restrictions on Chinese investment in U.S. companies and respond vigorously to alleged corporate espionage. It is also likely that the two countries would accuse one another of non-compliance before the ink on any trade deal has had time to dry.

Canada will have to adjust to the emergence of two major economic models

The Chinese model is increasingly state-driven and intolerant of political dissent, whereas the U.S. model continues to tilt towards free markets and democratic governance. **One example that highlights this contrast is the fact that the vast majority of Chinese companies (private and public) with more than three communist party members are required to set up communist party cells. This also applies to foreign companies involved in joint ventures with Chinese firms.**

These structural differences mean that the trade tensions with China are very different from the commercial disputes that the United States has had with other countries in the past. Historically, the United States has, up to a certain point, tolerated large trade deficits with Germany and Japan because these countries are close allies and democracies. In stark contrast, China is increasingly viewed by American politicians as an authoritarian rival intent on weakening the United States' global geopolitical and economic influence.

The emergence of two major economic models is also leading to the adoption of different technical standards across many sectors. This trend is being driven by China and the United States having decided to rely less on each other's technology and equipment. This means that, in addition to considering the quality of a company's products and services, investors must also begin to take into account their compatibility with either China's or the United States' technical standards.

[1] "Burned before, US pushes for way to enforce China trade deal," Associated Press, May 9, 2019.

Canada suffers collateral damage

The arrest of Meng Wenzhou—Huawei's Chief Financial Officer - in late 2018 in accordance with an extradition treaty signed with the United States is an example of how third parties can get caught in the crossfire. Needless to say that Canada's explanation to China that its judicial system is independent from the government was not well received.

Soon after Meng's arrest, Chinese authorities detained two Canadians for allegedly stealing state secrets. They have also halted canola imports, initiated lengthy inspections of soybean and pea imports, and suspended the permits of two major pork producers. The fact that African swine fever is decimating China's pig herds and that this in turn has reduced demand for livestock feed has made canola and soybeans an easy target. **From China's perspective, it has no choice but to impose harsh sanctions on Canada in order to dissuade other countries from taking similar measures against its national interests.**

Some analysts feel that, despite its strong public support of the World Trade Organization, Canada is reluctant to file a complaint with the WTO for fear of incurring further retaliatory action. Some would argue this lends credence to claims by the United States that the WTO is ineffective in dealing with Chinese trade infringements.

Ottawa's upcoming decision on Huawei likely to draw further reprisals

The Trudeau government is in the midst of conducting a national-security review to determine whether Canada should ban Huawei equipment from its 5G cellular infrastructure. Australia, New Zealand and Japan have already followed the United States' lead in excluding Huawei in this regard. India, Germany, France and the UK are considering tighter restrictions but not outright bans.

The Trump administration recently tightened the screws further by placing Huawei on a list of foreign firms that, beginning in late August, will be barred from receiving components from U.S. companies without official permission. The United States has accused Huawei of working for the Chinese government and engaging in activities hostile to U.S. national security interests. Huawei denies these accusations. It has been pointed out, also, that China does not allow foreign companies to build telecommunications networks in China. [2]

While Canada's decision on Huawei is probably still a few months away, the possibility of restrictions being implemented in the near future combined with the U.S. ban means certain of Canada's largest wireless service providers are exploring options for new equipment suppliers. Adding further pressure is the U.S. threat to limit intelligence-sharing with countries that allow Huawei equipment to be used in their telecom networks. Not surprisingly, China has publicly threatened reprisals if Canada does implement a ban. When Australia decided to exclude Huawei equipment from its 5G networks, China responded by significantly reducing coal imports from that country.

Being in the U.S. zone of influence a growing obstacle to greater economic ties with China

Canada's trade, security, geographic and cultural ties with the United States forces it to largely support U.S. positions regarding China. This means that as long as relations are strained between the two superpowers, Canada will be at risk for collateral damage.

The USMCA would, if approved, make it more difficult to tighten economic ties with China.

- Higher North American content requirements for manufacturing goods such as automobiles to retain duty-free status takes direct aim at Chinese industrial companies.
- Requiring members to give notice of any trade negotiations with a "nonmarket economy" and giving the other partners a say in the formulation of any subsequent deal is a way for the United States to dissuade Mexico and Canada from becoming too economically intertwined with China.
- The U.S. reached an agreement with Canada and Mexico to end tariffs on their steel and aluminum exports. This includes establishing a mechanism that prevents imports of unfairly subsidized steel and aluminum from countries outside of North America, including China.

Another factor hindering a deepening of economic ties with China is the strong possibility that China would insist that any trade deal allow China's state-owned enterprises (SOEs) to purchase Canadian companies. However, the United States has already indicated that allowing this in strategic sectors would likely result in less U.S. market access for these companies.

On the political front, the leader of the Conservative Party Andrew Scheer has promised to take a much harder line with China. More specifically, he has promised to ban Huawei products from Canada's 5G infrastructure, withdraw Canada from the China-led Asian Infrastructure Investment Bank, and deny Chinese SOEs "unfettered access to the Canadian market". The Conservative Party is currently leading in the polls. A federal election is scheduled this year for October 21.

[2] "Huawei restrictions are warranted despite no clear smoking gun," The Hill, March 6, 2019, and Rand Corporation.

Canada's guide to navigating this new trade environment

In this new global environment, Canadian investors must do more than simply analyze a company's fundamentals. They must focus on the country that the company considers its home base, and determine if that country's relations with its main trading partners are strained in a way that might impact its bottom line.

Canadian companies, meanwhile, must analyze whether their business models and supply chains are compatible with the geopolitical objectives of China, the United States and other major countries. This increases the risk of losing market share to competitors with inferior products and services owing to geopolitical factors.

Companies in strategic sectors 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. In an attempt to maintain some level of access to both markets, companies may have to set up two separate supply chains, one for the United States, the other for China. This would mean higher logistics costs for many companies, but with still no guarantee of maintaining market access.

Finally, even the signing of a trade deal between China and the United entails some risk for Canada. While Canadian companies would likely benefit from a China-U.S. deal that includes greater protection for intellectual property and a more level playing field, an agreement by China to substantially increase its purchase of various U.S. agricultural and energy products could reduce Chinese purchases of similar Canadian goods.

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