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U.S.-China truce: a pause in the great power competition

By Angelo Katsoras

Introduction

As expected, China and the United States agreed to restart trade negotiations on June 29th. **The good news is that in the short term both sides need a truce.** Failure to restart negotiations would have hurt market confidence and significantly weakened Trump's 2020 re-election prospects.

While President Xi does not have to worry about elections or a free press, he also has reasons to want a truce. China's economy is slowing down, rising wages are threatening competitiveness and certain companies are moving out their supply chains. Further, China remains highly reliant on certain American-made IT components.

All of these factors increases the chances of a deal being signed before the U.S. election.

However, the bad news is that there is no going back to how things were before. On the U.S. side, there is a bipartisan consensus that China has unfairly restricted access to U.S. companies and engaged in widespread intellectual property (IP) theft. This will make it politically impossible to unwind many of the recent restrictions placed on China. **Democratic Senator Chris Coons summarized the mood in Washington when he said that being a hawk on China in today's Congress was "comparable to the 1950s when there was no downside, politically, to being anti-Soviet".**

As for China, the sting of being repeatedly hit by tariffs and bans on the purchase of U.S. technology means it will double down on efforts to develop its own expertise in key sectors. **Indeed, one can reasonably assume that the 10,000 developers that Huawei has directed to work round the clock to replace American IT components and software have not at all relented in their mission because of the trade truce.**[1] In fact, the Chinese government has announced investments of well over $100 billion over the next decade in a bid to catch up to the United States in the fields of semiconductor technology, artificial intelligence, and quantum computing.[2]

Deal or not, both countries want to become less economically reliant on the other. Any deal that is signed would likely also be very precarious as both sides would soon accuse one another of non-compliance. Their intense competition to be the world's dominant geopolitical power and leader in tomorrow's technologies means the stakes are too high for either side to easily accept second place.

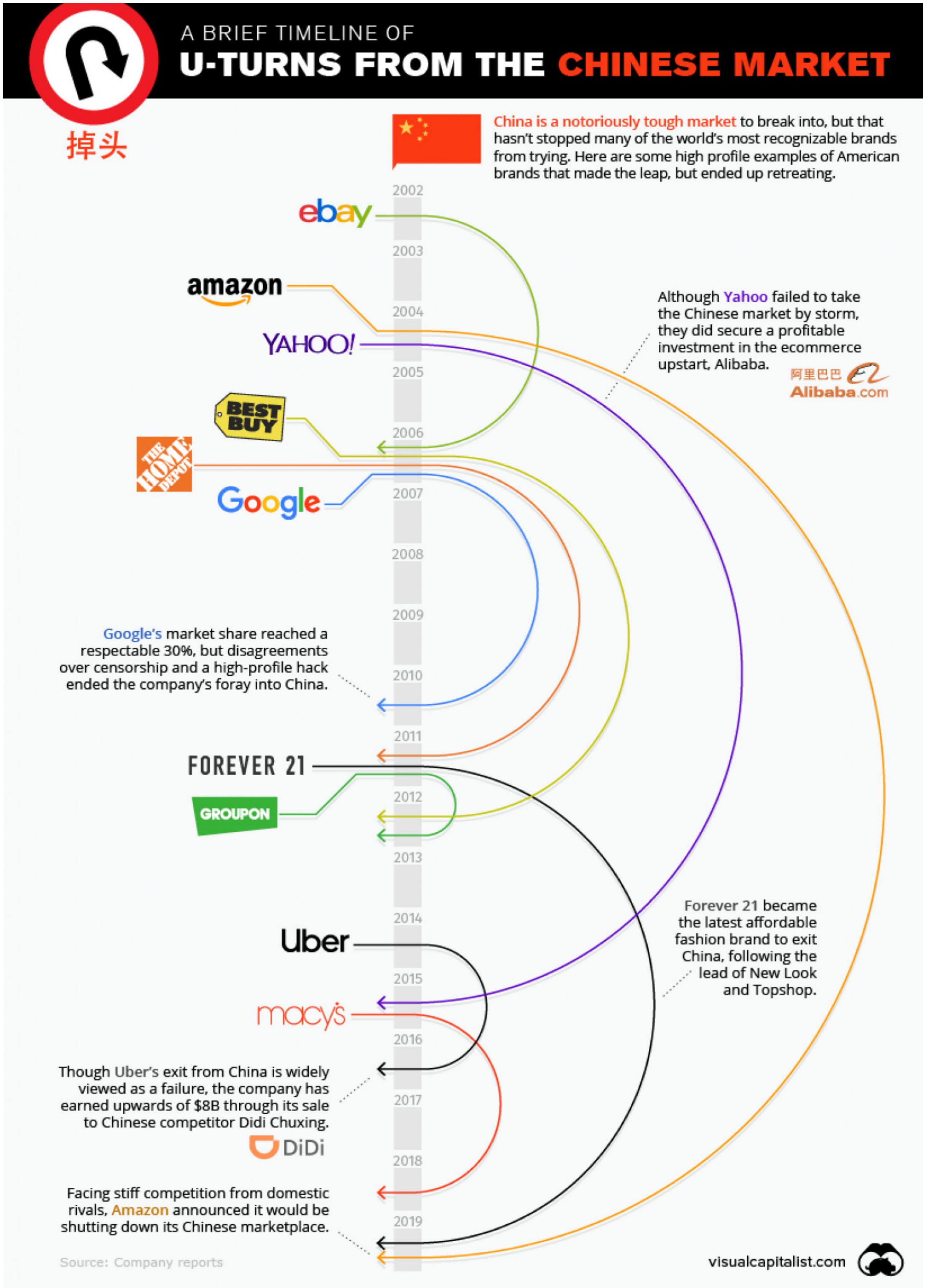
Growing divide between the two has been a long time in the making

The widespread view among the policy elite in Washington is that long before U.S. President Donald Trump began the trade war, China had already spent nearly two decades restricting market access to U.S. companies such as Google and Facebook.

The plight of American credit card companies is another often cited example. In exchange for being allowed to join the WTO in 1999, China promised to allow these companies access to the Chinese market by 2006. Despite winning a WTO court case in 2012, American credit cards are still not widely accepted in China. American Express at the end of last year finally received preliminary approval from China's central bank to issue credit cards, but it is still at least 12 months away from going into effect.[3] However, this opening is considered to be too little, too late. In China, this market is already dominated by the likes of Alipay, WeChat Pay, and UnionPay.

Indeed, as the following chart illustrates, there are many examples of U.S. corporations that entered the Chinese market with great fanfare only to retreat several years later owing to what some claim to be an uneven playing field.

[1] "Huawei Digs In for a Drawn-Out Battle With Trump's White House," Bloomberg, June 5, 2019
[2] "Winning the Future," Semiconductor Industry Association, April 2019
[3] "It's Time for America to Break with Beijing," National Review, June 19, 2019



Source: A Timeline of U.S. U-Turns From the Chinese Market, Stratfor, June 20, 2019

It will be near impossible for U.S. to unwind many restrictions placed on China

Below are some recent examples of legislation and regulatory actions targeting China.

- Restrictions on Huawei: Despite the truce, certain restrictions on selling components to Huawei will remain in place. Further, given the strong anti-China tilt in both political parties and in U.S. national security circles, these restrictions could remain tighter than many expect. Indeed, recent concessions by Trump regarding Huawei have already drawn criticism from both sides of the aisle. Democratic Senate leader Chuck Schumer said: "If President Trump backs off, as it appears he is doing, it will dramatically undercut our ability to change China's unfair trade practices." For his part, Republican Senator Marco Rubio tweeted: "If President Trump has agreed to reverse recent sanctions against #Huawei he has made a catastrophic mistake."
- Committee on Foreign Investment in the United States (CFIUS). In mid-2018, Congress voted overwhelmingly to broaden the power of CFIUS to block transactions deemed a threat to national security (both economic and political). This includes any foreign investment over 5% in various technologies including biotech. As a result, Chinese investments in U.S. biotech ventures were $725 million in the first half of 2019, down from $1.65 billion in the same period last year.[4] CFIUS recently ordered the Chinese company, iCarbonX, to sell its stakes in two U.S. companies, PatientsLikeMe and HealthTell, because it was reportedly worried that these investments could be used to obtain sensitive personal information about Americans.
- Department of Justice: Last November, the Department of Justice established a China Threat Initiative to detect corporate espionage. Soon after, Yi-Chi Shih, a part-time professor at UCLA, was found guilty of attempting to export sensitive electronics with military uses to China. He could face a prison sentence of over 200 years.[5]
- Supercomputing: In late June the Commerce Department blacklisted five Chinese supercomputing firms for reasons of national security. American firms are barred from selling chips and interconnects, hardware that allows chips to communicate with each other, to these companies.[6] Supercomputers are crucial to the development of missile defence, encryption and other cutting-edge IT sectors.
- Restriction on hiring of Chinese nationals: The U.S. Commerce Department has sharply restricted the ability of IT companies to hire Chinese nationals for advanced engineering projects. The number of work permits granted in this regard went from 771 in 2017 to 350 last year.[7]

Potential further restrictions:

- Fentanyl Sanctions. Democratic Senator Chuck Schumer and Republican Senator Tom Cotton have cosponsored a bill called the Fentanyl Sanctions Act that would grant law enforcement greater powers to combat opioid trafficking into the United States. In a recent article on the subject that they published jointly, the two stated: "China is currently the world's largest producer of illicit fentanyl, much of which ends up in the United States."[8]
- Hong Kong Human Rights and Democracy Act. Republican Senator Marco Rubio and Democratic Congressman Jim McGovern introduced legislation that would require an annual assessment of Hong Kong's political and legal autonomy to determine whether it still qualifies for special trade status. Eliminating this status would subject Hong Kong to the same tariffs as China and threaten its standing as an international financial centre.[9]
- Surveillance Technology. The Trump administration is considering requiring that American companies obtain government approval to supply components to Hikvision, one of the world's largest manufacturers of video surveillance products. If imposed, it would mark the first time the Trump administration punished a Chinese company for its alleged role in the surveillance and mass detention of Uighurs, a Muslim ethnic minority in China.
- Chinese Banks and North Korea. The U.S. Senate inserted language in the National Defense Authorization Act that would ban Chinese banks that do business with North Korea from the U.S. financial system. The Senate approved the measure by an 86-8 vote.

The strong bipartisan anger towards China increases the odds of at least some of these bills being approved even in the face of presidential resistance. Overriding a presidential veto requires a two-thirds majority in both chambers of Congress.

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[4] "Chinese VC spending on US biotech hit by security reviews," Financial Times, July 8, 2019
[5] "Electrical engineer found guilty in China weapons tech export plot," AFP, July 2, 2019
[6] "An American ban hits China's supercomputer industry," The Economist, June 29, 2019
[7] "U.S. Targets China's Supercomputing Push With New Export Restrictions," Wall Street Journal, June 21, 2019
[8] "Schumer & Cotton: Our bipartisan 'Fentanyl Sanctions Act' targets traffickers like China," USA Today, June 18, 2019
[9] "Washington can pull the plug on Hong Kong's economic model at any moment," The Telegraph, June 16, 2019

Shifting production out of China

A growing number of companies have decided to shift at least some of their operations from China. In certain cases, the uncertainty over trade tensions was the final tipping point for companies already struggling with rising labour costs and worries over IP protection.

United States

Hasbro: The toy maker is transferring most of its production from China to Mexico, Vietnam and India.

Steve Madden: The footwear and handbag maker is sending some production to Cambodia.

Stanley Black & Decker: The toolmaker is moving production of its Craftsman brand to the United States.

Brooks Running: The footwear company is relocating production from China to Vietnam.

Whirlpool Corporation: The appliance maker is moving production of some of its KitchenAid appliances from China to the United States.[10]

GoPro: The camera maker is planning to transfer production of U.S.-bound cameras to Mexico.

Apple: It has reportedly asked its major suppliers to evaluate the costs of shifting 15% to 30% of their production capacity from China to countries such as Mexico, India, Vietnam, and Indonesia.[11]

Taiwan

Pegatron: The electronic manufacturing company is planning to build a $1-billion plant in Indonesia.

Foxconn and Wistron: These two Taiwanese Apple suppliers are planning to expand their presence in India, where they each already have an iPhone factory.

Taiwan's strong economic reliance on China limits how much it can diversify production from China, however. China accounts for 40% of its exports and some 1 million Taiwanese work there.[12]

South Korea

Tariffs and rising wages are not the only reason some companies are leaving China in whole or in part. Another is being continually targeted by boycotts during periods of high tension between South Korea and China. China's reaction to Seoul's deployment in 2017 of a U.S. missile-defence system to protect against North Korea is a case in point. After being targeted by boycotts and suffering significant losses, South Korean retailer Lotte Mart decided to exit China.

- Samsung Electronics recently confirmed the imminent closure of its last smartphone factory in China. It has been shifting its production from China to Vietnam for many years.
- LG Electronics: The appliance maker recently moved the production of U.S.-bound refrigerators from China to South Korea.[13]

Nokia and Ericsson, Huawei's biggest competitors, will likely to reconfigure supply chains

There are growing indications that for Nokia and Ericsson to have a chance of maintaining some access to both the U.S. and Chinese telecom markets, they may have to set up two separate supply chains: one for the United States and, the other for China. This line of thinking has been bolstered by reports the United States is considering requiring that 5G cellular equipment used within in its borders be designed and manufactured outside of China.[14]

[10] "Apple, Black & Decker and Steve Madden among US companies moving production out of China," Fox Business, June 20, 2019
[11] "Apple weighs 15%-30% capacity shift out of China amid trade war," Nikkei Asian Review, June 19, 2019
[12] "Taiwan's computing titans are caught up in the US-China tech war," Economist, June 10, 2019
[13] "South Korean companies shift production out of China," Nikkei Asian Review, June 22, 2109
[14] "U.S. Considers Requiring 5G Equipment for Domestic Use Be Made Outside China," Wall Street Journal, June 23, 2019

Some Chinese companies are also looking to move operations abroad

Companies planning to relocate production from China to Southeast Asian nations or elsewhere

Company/main business	Places to which production is planned to be shifted
China	
Advanced Technology & Materials *Metals, machine tools*	Thailand
Goertek *Earphones*	Vietnam
Hangzhou Great Star Industrial *Tools*	Vietnam
Jiangsu General Science Technology *Tire*	Thailand
KingClean Electric *Home electronics*	Vietnam
Lenovo Group *Personal computers*	Vietnam
Shenzhen H&T Intelligent Control *Home appliances, electric devices*	Vietnam
TCL *Home electronics*	Vietnam
Zhejiang Chenfeng Technology *Lighting equipment*	India
Zhejiang Hailide New Material *Chemicals*	Vietnam
Zhejiang Henglin Chair Industry *Furniture*	Vietnam
Zhejiang Jasan Holding Group *Textile*	Vietnam

Source: "Trade war steers Chinese investment toward Southeast Asia," Nikki Asian review, June 10, 2019

Countries well positioned to benefit from production shifting from China

In a poll conducted in late May, the American Chamber of Commerce in China found that 40% of its member companies had moved operations out of China or were considering doing so. Among these members, Southeast Asia (24.7%) and Mexico (10.5%) were the preferred destinations. Fewer than 6% said they had contemplated relocating manufacturing operations to the United States.

Vietnam among biggest winners of U.S.-China trade war

Low wages, a growing network of free trade agreements, and openness to foreign investment leaves Vietnam well positioned to benefit from U.S.-China trade tensions. The fact that the United States and Vietnam are both interested in cultivating alliances that counterbalance China's rising power is an added bonus. However, Vietnam faces two major challenges in this regard.

- The more that investment pours into Vietnam, the more challenging it will become to manage rising labour/land costs and transportation infrastructure bottlenecks
- Efforts by certain exporters to redirect goods from China and other countries to Vietnam so that they can be re-exported to the United States as made in Vietnam in order to pay lower tariffs has already come under fire. The U.S. Commerce Department decision to impose duties of over 400% on steel imports from Vietnam because of allegations they were essentially produced in South Korea and Taiwan and only shipped to Vietnam for minor processing before being exported to the United States is a case in point.

Mexico another potential winner over long term

Despite Trump's rhetoric against Mexico, the country has three long-term advantages in this new trade environment: 1) it has relatively open access to the U.S. market; 2) an economically stable Mexico is in America's long-term interests; and 3) imports from Mexico tend to have significant U.S. input. Mexican exports on average have about 35% U.S. content, versus only 4% for Chinese exports.[15]

U.S. imported less from China in Q1 but more from elsewhere

2018 rank	Source country	2018 total (millions)	Q1 2019 YoY growth
1	China	539,676	-13.9%
2	Mexico	346,101	5.9%
3	Canada	318,824	-3.6%
4	Japan	142,425	3.0%
5	Germany	125,849	1.2%
6	South Korea	74,264	18.4%
7	United Kingdom	60,783	2.5%
8	Ireland	57,454	1.0%
9	Italy	54,744	7.8%
10	India	54,349	15.1%
11	France	52,732	16.6%
12	Vietnam	49,174	40.3%

Source: NBF Economics and Strategy (data via Refinitiv & U.S. Commerce Department)

Conclusion

Whether or not a trade deal is ever reached, investors and businesses must learn to navigate a world that features two superpowers with radically different economic systems and a deep and growing mutual suspicion.

This includes navigating a maze of contradictory rules where complying with U.S. regulations can place a company in violation of Chinese laws, and vice versa. China's recent warning to global IT companies that they could face dire consequences if they abide by the Trump administration's ban on the sale of key American technology to Chinese companies highlights this risk.

Consequently, the supply chains of many global companies will have to become more geographically diversified in order to become less vulnerable to disruption from trade tensions and great power politics. Gone are the days when major corporations could rely on a seamless global supply chain. Unfortunately, the fragmentation of supply chains will likely translate into loss of efficiency and higher costs.

As China and America wall off their IT markets from one another, their respective companies will engage in even more intense competition for market share in other countries. This will likely place these countries under increasing pressure to choose one superpower over the other.

[15] "Trump's Mexico Tariff Threat Trips Up Manufacturers Shifting Out of China," Wall Street Journal, June 2, 2019

More companies to adopt localized manufacturing practices

Growing protectionism will in some instances encourage corporations to base production close to the point of consumption. This may mean, for example, that instead of manufacturing goods mostly for export, many factories in China will increasingly produce goods for domestic and nearby regional markets. Companies that decide to service the North American markets from, say, the United States will likely resort to automation rather than hire large numbers of workers. Under this scenario smaller countries without bilateral trade deals are at a particular disadvantage because they do not have the large domestic markets to pressure companies to set up operations in exchange for greater market access.

Bottom line

While the chances of deal being reached before the U.S. presidential elections are high, we remain skeptical about the potential for a long lasting trade deal between the U.S. and China. The way each side looks at the question of intellectual property protection is but one example of how different interpretations could threaten any deal. China supports the protection of intellectual property rights with the understanding that foreign firms should be allowed to voluntarily share their technology with Chinese firms. The U.S. in contrast strongly feels that this would assist in the continuation of forced IP transfers by disguising them as voluntary.[16]

The road to dual supply chains will be a rocky one.

[16] "How China Really Sees the Trade War," Foreign Affairs, June 27, 2019

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