

# China Watch

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S U M M E R 2 0 1 8

*One whose boldness leads them to venture will be slain;  
One who is brave enough not to venture will live.*

Laozi, fifth century BCE

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## Uneasy allies

**P**resident Trump seems intent on preventing China from becoming great again. In April 2018, Trump signalled his intention to place tariffs on over 1000 Chinese products, claiming that the United States was a victim of unfair trade with China that resulted in a deficit of hundreds of billions. China immediately threatened retaliatory tariffs. On 20 May, the US and China issued a communiqué stating an agreement had been reached and that punitive tariffs would not be imposed. But in little over a week, Trump backtracked and announced that, in the interest of national security, he would impose a 25% tariff on USD 50 billion of Chinese imports containing 'industrially significant' technology.

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President Trump may be pursuing a deliberate strategy to un-nerve Beijing, or perhaps he and his cohort are fielding competing petitions daily from commercial and political interest groups, yielding to some and reacting to others, resulting in a flood of contradictory decisions. The US and China are likely to arrive at a long, uneasy truce rather than a binding agreement or

a full-scale trade war, but any conflict will exact an unnecessary cost on the global economy.

*This is not about trade or deficits. This is about containment. If you contain China's ability to develop technologically, you contain China's power.*

Washington-based economist

The Chinese and US economies can endure a limited trade war, but neither country nor the global economy can afford a protracted confrontation. The US buys electronic and high-tech products from China that it cannot manufacture in quantity competitively elsewhere (USD 147 billion in 2017). It also buys an array of appliances and other basic household items (USD 88 billion in 2017) that has allowed American families to maintain reasonably low living costs for decades. In 2017 China imported USD 20 billion worth of agricultural products from the US. It may source some of these from other countries, such as soybeans from Argentina, but shifting to other suppliers could result in inflation of food prices, the most sensitive segment in the consumer price index, for even small increases impact the country's more economically vulnerable citizens.

*Of course those of us in the middle class are sensitive to food prices going up, but we can afford higher costs. It hurts millions working in the service sector and migrant workers. A construction worker coming to Beijing to save money usually lives in a dormitory on the building site, and so their only real cost is food. The whole point of them leaving rural areas for a year at a time is to save money for their families.*

Beijing sales manager

China also depends to some degree on the US for new technology. In the ongoing negotiations, China hoped that the Washington-imposed prohibition on selling sophisticated (particularly military) technology to China would be loosened, on the basis that this would help to reduce the trade deficit. If enhanced US sanctions on Chinese technology products are implemented by the end of June as threatened, the chances of any relaxation of American export restrictions will be slim.

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China and the US are commercially interdependent and this reality rankles with them both. What is often framed as a trade war

between strategic competitors could be more accurately described as disputes between uncomfortable economic partners.

*China is fighting as a matter of principle. But it can compromise because the buying power of the Chinese state is huge. A Boeing Dreamliner costs more than 150 million dollars. An advance order of a fleet of aircraft would make a real difference to the deficit, but China isn't going to be threatened into deals like Trump thinks.*

American fund manager in Beijing

## Everybody loses

In trade wars there are only losers. Simply observing the economic suffering of the opposition does not diminish your own. While politicians wrangle, effectively holding their populations hostage in order to achieve a perceived edge over a rival country, ordinary consumers suffer.

The Chinese people are relatively inured to economic deprivation in a way few citizens in Western nations can conceive. However, if the Chinese people were to face severe food inflation and unemployment for a protracted period, their faith in their leaders would begin to erode and the Communist Party would be vulnerable. Each year there are tens of thousands of protests in China, not so much against the Party in Beijing, but as a form of petition to it for action against corruption and the unpopular conduct of local officials. In a marked economic downturn such protests could coalesce into nationwide criticism of the central leadership.

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But the US Government is taking the greater risk. In a trade war, even flawed democracies such as the US are far more vulnerable in the short term than one-party states, for voters are freer to react and to punish their leaders swiftly through the ballot box when their economic

circumstances deteriorate. In this age of populism spawned by the failure of the Western elite to manage economic and social cohesion, charismatic candidates in Western democracies are exploiting nationalist rhetoric and offering unsustainable protectionist strategies as answers for society's ills.

Rather than confronting their nation's own contradictions and implementing economic reforms, American politicians have commonly blamed trading partners for the country's unbalanced economy, appealing to American exceptionalism, nostalgia for past greatness (real and imagined), and the isolation of mind that appears increasingly common in this continental power. The US is still the strongest economy in the world and has the resources, credit-worthiness and comprehensive power to rebalance its economy, but it seems, like many indebted Western nations, to lack the political will.

Trump has said that he would incentivise, or if necessary penalise, American companies so they did not move jobs to China and other lower-cost markets. The accumulated US investment in China over the last 30 years is over USD 250 billion, and while there has been a transfer of jobs from the US to China, it has also allowed US companies to expand and thrive, creating high-paying jobs in the US to service the China market and the global markets into which they sell from China.

*We exclusively manufacture in China. We source raw materials domestically and employ well paid and highly skilled staff such as scientists and designers in both the US and China. These are the strengths of our work force and areas where we can compete. Our markets are mostly in developed countries, but without Chinese manufacturing we could not operate.*

US executive

What Trump and other American politicians do not talk about is the fact that the US and China have benefited greatly from the last three decades of economic partnership, but that the spoils of the relationship have been unevenly distributed. China does not 'steal American jobs' each year, a claim that Democrats and Republicans reach rare agreement on. American investment into the Chinese economy is now no more than 2% of total US foreign investment. Whatever deals American trade negotiators may strike with China, the deficit will not change markedly, although the US government may find a way to spin the outcomes to claim victory.

## Fake economics

Trump's figures are misleading. The US Government's official data have the trade deficit with China in 2017 at USD 375 billion when accounting only for goods, and USD 336 billion when services are included (lower than Trump's alleged USD 500 billion). Taking these figures as a direct representation of the trade imbalance would be misreading the nature of global supply chains, of which China is often the last stage.

Take Apple's iPhone, which is assembled in China from components sourced around the world. The flagship iPhone X costs approximately USD 400 to manufacture and sells for around USD 800 wholesale and USD 1200 retail. Of the USD 400 manufacturing cost, only 3-6% goes to China-based contract manufacturers such as Taiwanese-owned Foxconn that assemble the final product; most of the rest goes to high-tech parts manufacturers in other countries. Apple's iPhone 7/7S series alone (of which 61 million units

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were shipped to the US in 2017) accounted for nearly USD 16 billion (over 4%) of the official USD 375 billion goods deficit.

In calculating its deficit with China, Washington uses the gross value of other imported products as it does with the iPhone, resulting in a severely distorted total number. American corporations exporting Chinese-assembled but US-branded products back to the US — with the majority of profits flowing to the US and other countries (including tax havens) — accounted for over half of the total goods deficit.

In an increasingly global economy, cross-border trade captures only a part of true economic exchange. Deutsche Bank estimated that in 2015, US companies' China-based subsidiaries sold USD 223 billion worth of goods and services to Chinese consumers, while in the same year, Chinese companies' US-based subsidiaries sold approximately only 10% as much to American consumers (USD 22 billion).

Trump and his advisors miss the point that no other country is responsible for the fact that in the last forty years the US has lived, and continues to live, beyond its means. The US suffers from a multilateral trade imbalance stemming from consuming more than it produces, rather than just a bilateral problem with China.

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A trade war with China is, by association, also a trade war with longstanding US allies like Japan, South Korea, Taiwan, Canada, and much of

Southeast Asia. Along with its allies, the US risks damaging its own companies such as Boeing, Ford, Starbucks, KFC and Apple, all of which sell to or manufacture significantly in China. This is a war which would see the US engaging in an act of economic self-harm.

It is ironic that while Trump's narrative of the Chinese 'ripping off America' and 'stealing American jobs' has won him crucial support in the struggling manufacturing and agricultural states, these same states have the most to lose in a trade war with China. Lost American manufacturing jobs are unlikely to return, as they were lost primarily to globalisation and improved automation years ago, but the US agricultural sector remains strong and adaptable.

In response to Chinese demand, many states in the American Midwest have been cultivating soybeans rather than corn, and for the first time in 35 years soybeans constitute a larger national crop. China has identified US soybeans, sorghum, corn, wheat, beef, and pork for potential retaliatory tariffs. This is despite China's generally favourable stance toward US agricultural imports, with a 19 May report from a Ministry of Agriculture official stating that continued agricultural imports (including from the US) will remain a feature of China's open economy and a necessity for Chinese consumers. If China retaliates against US agriculture in response to any American tariffs on its technology exports, the Republican Party may struggle to survive the midterm elections in November.

*My concern is that China will eventually be able to source elsewhere many of the farm products it presently sources from the United States. Once this crisis has passed, I expect that China will find ways to avoid being held to ransom by the USA on anything related to food, particularly soybeans, which are important to the Chinese diet and also the animal feed industry. In the end, American farmers will lose as a result of this confrontation.*

American agricultural scientist

The powerful business lobbies that back both the Republican and Democratic parties understand how vital free trade is to the American economy, and that the US is still the world's economic superpower largely because of the relatively open global economy that it contributed to creating. Despite its presently volatile and polarised political culture, the US remains an industrious and innovative nation of strong institutions. The global economy continues to recover, lifting the US economy with it. Economic uncertainty stemming from a trade war could slow or even reverse this recovery.

## Disillusioned with China

American companies were once enamoured of the opportunities in China, and the American Chamber of Commerce in China lobbied Washington successfully for two decades to prevent China from being sanctioned, particularly in regard to its trading status as a most favoured nation. The same businesses are less optimistic today.

*We need to challenge China in so many areas of IP protection and market access. As Americans, we used to enjoy some preferences in China. I saw China and the United States in a partnership in which both countries made a great effort to understand and accommodate each other. Now it feels more like a bad marriage. It could be repaired, but Trump's exaggerations and grandstanding on these issues are not helping. If anything it will make the relationship worse. He is a terrible negotiator.*

American manufacturer in Shanghai

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Most American companies want pressure brought to bear on China to open its markets further and reduce unfair advantages stemming from state support of domestic companies. Foreign firms in general resent pressure to transfer technology to their Chinese partners.

This has led to some firms withholding their intellectual property and paying higher tariffs to export completed products to China, for example the technology essential to China's high-speed railways. China often applies such technology without being able to crack the essential systems.

For all its present inconsistencies the passage of negotiations may give foreign, particularly American, companies a chance to deal with some of this inequitable treatment.

*China became puffed up with its economic successes and Western companies accepted increased commercial restrictions because they were afraid of missing out on what they saw as the real growth story in the global economy. We lost confidence in ourselves after the financial crisis and China lost confidence in our economic and social models. Our model is still the best there is but we need to have more respect for it and apply it more carefully.*

US businesswoman in Shanghai

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If the US focused on securing more just policies for all foreign investors rather than correcting spurious trade imbalances, American businesses would benefit. China has a highly restricted service sector, which not only inhibits the development of its financial and legal systems and restrains the Chinese economy as a whole, but fuels the ire of foreign companies in

China. Recent Chinese announcements that the financial sector will open to more foreign participation are more rhetorical than conciliatory. The stockbroking and insurance industries picked by the Chinese Government are already sewn up by a few dominant national players.

The Chinese Government, and more importantly private Chinese businesses, have historically done what was needed to rise from economic servility and insolvency following the decades of command economic stagnation of the communist years. In the last four decades, the Chinese state has been incrementally enfranchising the domestic private sector in order to avoid the shock and unemployment that comes from rapid privatisation, and to maintain the control over the economy that underpins its political power. It is without precedent in modern economic history and may be what is meant by a 'socialist market economy' or 'socialism with Chinese characteristics'; the reality might be more accurately described as a 'free market economy with state capitalist characteristics'. This approach has caused many market distortions, but has also lent a degree of stability through what has otherwise been a period of relentless, turbulent economic and social change.

Although the private sector contributes over 60% of China's GDP growth and over 80% of jobs, as the state leases land to businesses and controls all the key utilities upon which business depends, private companies and the state must work together closely for each to develop. When foreign companies engage in an economy that is founded on such an alliance, it can be hard to compete.

*We are often told by local Chinese officials that they cannot help us when we are trying to restructure foreign investments in their cities. They say there are no direct links between the government and local businesses, and especially local private companies. In fact few deals get done without the sanction and oversight of local officials. These same officials hold many keys to a company's success once it is in operation, so when it fails, if you are diplomatic and persistent, you may find the officials can play a key role in sorting out problems. They know that the failures of foreign invested private companies risk being perceived as local political failures.*

Beijing-based Western fund manager

## Time for a new partnership

Some in China want to avenge the injuries of the colonial past and believe that they should coddle domestic industries and make foreign companies

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pay premiums to do business in their domestic market. This stance of victimhood will only weaken China in the long run. Trump's trade war is foolish, but China has in some respects opened itself to resentment from the trading partners upon which it depends.

China has observed that powerful economies may agree to shared rules within multilateral institutions that are meant to apply fairly to global markets, but operate by their own rules when it suits them. The US was keen for China to join the WTO so it could be part of a global rules-based trading system, but now for domestic political purposes, Washington has chosen to challenge China on a bilateral basis. Rather than picking a to-date largely rhetorical fight, it would have been more productive to accelerate negotiations within the parameters of the existing draft of the US-China Bilateral Investment Treaty. China is becoming increasingly inclined, in an unjust world, to see how it can also play by its own rules on regional and global issues.

There is usually an overarching motive in Washington's desire for a confrontation with Beijing: containment. One of the US' deep concerns is China's increasing competitiveness in high technology, and it has sought to prevent or at least delay China from becoming an advanced technological power, particularly in the military and aerospace sectors. China may lag far behind the US in innovation but it has found ways to adapt the technology it needs, develop local versions of cutting-edge systems, and increasingly innovate, thereby circumventing Washington's long-standing high-tech prohibitions. Today China produces more manufactured goods by value than ever before.



Attempts to contain China have so far and will ultimately be futile, for China will create, purchase, purloin or pirate the technology it needs, just as it has been doing for decades. Much of the American Industrial Revolution in the 18th and 19th centuries was built on stealing technology from Britain and Europe. Such piracy fuelled the development of Japan in the 1950s and 1960s and lifted the living standards of Hong Kong and Korea from the 1960s to the 1980s. Evolving an economic partnership based on the US and China's best firms sharing and protecting each other's IP is the only long-term solution for regional and global peace and stability.

A multilateral discussion aiming not just for a Sino-American deal but a North Asia trade accord would help prevent a damaging stand-off and underpin growth and stability for all participants. The fact that the world is now multipolar rather than bipolar is even more reason for nations to work together. But such accord is less likely than continued economic and strategic tremors as the US — perhaps the world's greatest yet shortest-lived empire — confronts the world's oldest continuous culture in its rise to reclaim its place as a global power.

With America's domestic uncertainty in the face of its shrinking global influence, and China's growing confidence as it converts its economic power to political leverage, greater wisdom will be needed in Washington and Beijing than has been shown to date. The global economy is recovering in a more tangible way than in any year since the Global Financial Crisis. It would be folly to damage that recovery with a trade war between the world's two largest economies.

Even with an injurious trade conflict, China's GDP will continue to grow, from 5% to 7% in the next few years, and absent a trade war, for the next five to eight years. These dynamic years of growth and consolidation will be driven by the continued conversion of rural labour to the urban industrial and service sectors, and eventually, further opening to deeper global participation in its economy. Even with the distractions of trade disputes or the temporary burden of higher tariffs in the West, China will continue to drive growth and wealth in the global economy. It would be better for all if it did so in co-operation rather than enmity with the United States. ☹️