Technology, Trade War and Hard Decisions: ZTE and More

US-China trade relations unlikely to improve any time soon for one simple reason.

Matthew van Putten

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Matthew van Putten is federal research manager and editorial coordinator for GovernmentCIO. A graduate of Johns Hopkins SAIS Strategic Studies and International Economics programs, he focuses on strategic affairs, Chinese financial markets, African politics and the impact of technology on international politics. Read his first column on ZTE here.

On May 28, the White House laid out the terms by which Chinese telecom giant ZTE could reenter the U.S. market. A few days later, the White House announced the onset of 25 percent tariffs on $50 billion in Chinese goods. To some, these moves
seem contradictory, one an attempt to help a distressed Chinese company and the other a demonstration of willingness to use protectionist measures to hurt the Chinese economy more broadly.

President Donald Trump on May 13 (as well as May 14, 16 and 25) tweeted he and Chinese President Xi Jinping would find a way for ZTE to “get back into business, fast.” From the beginning, this confused many China-watchers, trade hawks, policymakers and market players — implying either 1) a large change in tone toward China or 2) a tactical concession in the name of achieving a wider strategic goal.

If the first scenario is correct, the U.S. may be weakening its stance toward a trade war, lowering investment restrictions, weakening the Committee on Foreign Investment in the United States, and even pulling back from tariff threats. With the second scenario, Trump may be demonstrating his ability to help a particular Chinese firm, a clear signal of willingness to deal. Perhaps the president considers it essential to keep China happy in the run-up to a potential U.S.-North Korea summit and a comprehensive U.S.-China trade accord.

Because of China’s strategic goals and the relative lack of benefits on the part of the U.S., China is in a far weaker position than is generally believed. The Chinese government must carefully consider how to achieve its goals of supporting technological advancement, arriving as a full-fledged tech leader in biopharmaceuticals, artificial intelligence, telecom and the six remaining sectors outlined in Made in China 2025.

At a fundamental level, the U.S. and China’s economic relationship suffers from one central problem, one that sits under all of the chatter, wrangling and negotiation between U.S. and Chinese officials. Though rarely spoken about in U.S. policy circles, the fundamental trade problem between the U.S. and China is that Chinese do not consume very much relative to the size of their economy, the opposite of the U.S. If China were to significantly reduce the trade deficit, as the administration demands, it will find itself with significantly higher debt, unemployment or more likely both. Such shocks would make it much harder for China to achieve its technological ambitions.

On the American side, it is easy to blame currency manipulation, trade barriers, subsidies to Chinese firms, government protections that prevent major corporations
like Facebook or Google from entering the Chinese market, Chinese restrictions on foreign investment, Chinese state-sponsored IP operations, artificially low (and sometimes negative in real terms) interest rates or Chinese requirements that American companies that seek to operate in China must give over their IP. In theory, all of these factors negatively affect the trade balance by reducing the ability of Chinese consumers to purchase American goods.

Yet, there is a deeper structural problem — Chinese households simply earn too small of share of their national income. Even if China were to reverse every single policy advocated by American policymakers, the trade deficit would remain, though perhaps reduced. Capital flows and the very structure of the Chinese economy make elimination of the U.S. deficit all but impossible.

Because of the nature of the two economies’ growth models, they treat workers differently. An American worker takes home approximately $75 out of every $100 she produces (in the aggregate), while a Chinese worker takes home about $60 out of every $100 she produces. This explains why over time imbalances have gotten worse, not better. This is clearly bad for the ability of Chinese to consume. As long as the U.S. has the world’s most open and liquid capital markets, American producers will always be at a disadvantage vis a vis China.

This underlying structural reality will constrain China’s ability to respond to the Trump administration’s demands that China shrink the Chinese trade surplus with the U.S., remove Chinese subsidies for advanced tech companies and industrial giants, and lower tariffs to U.S. levels and other measures.

The Chinese economy is among the most extreme cases in history, in terms of the share of national wealth and income controlled by the state and the state-aligned corporate sector. Though a benefit in some ways, this may prove a more dangerous dynamic to Chinese innovation than competition or trade conflict with the U.S.

In China, certain sectors of the economy, often called the “vested interests” by the Chinese press, have received outsized benefits from China’s unrivaled four decades of growth, averaging over roughly 8.5 percent a year. Local governments, state-owned enterprises and the wealthy families that dominate Chinese politics have benefited through by an increasing share of the rapidly growing national pie. If China is ever to support as large a consumer market as would be justified by its GDP, purchasing power must migrate from the “vested interests” to ordinary
Chinese. Otherwise, consumption must remain anemic.

What does this mean for tech companies and the future of Chinese innovation?

China has a smaller consumer market than would otherwise justify the massive investments into plant, equipment and research. This is where government support plays a role. From protecting the domestic market to providing subsidies and cheap loans through state-controlled banks, Chinese tech firms may find themselves in jeopardy without political support.

In other words, the Chinese advanced-tech sector requires ongoing government support and external demand. Chinese economic planners continue to affirm the necessity for an export surplus, despite statements that China will buy “more” from the U.S.

In negotiations, Treasury Secretary Steven Mnuchin’s Chinese counterpart Liu He put forward the Chinese position that China is willing to contribute toward the U.S. desire for greater trade equity through larger purchases of U.S technology, a position welcomed by many U.S. tech producers. Yet, one must ask what strategic benefit the U.S. gains from such an outcome, as acquiring foreign technology, tech companies and advanced tech products is one of the major pillars of the Made in China 2025 plan, meant to replace the U.S. as the world’s technological epicenter.

For advanced tech to be scalable, you need a large market in which to sell, so firms that invest in R&D and productive capacity can remain profitable. China currently exports 25 percent advanced tech products, but to compete with Japan, the U.S., the EU and Korea, it will need to move up the value-added chain.

The goal of Made in China 2025 is to make China 1) technologically self-sufficient and 2) the global leader in advanced tech fields (the 10 areas of emphasis include the following: IT, robotics, aerospace equipment, ocean engineering and high-tech ships, railway equipment, energy saving and new energy vehicles, smart grid and power equipment, new materials, medicine and medical devices and agricultural machinery).

To do this, the Chinese government has laid out guidelines for channeling public and private funding into companies and research designated relevant to these fields to hit investment and research targets. These, combined with guidelines for ensuring market access abroad and preferential treatment at home and financial
and political support for acquiring foreign technology, have angered many producers from across the world, from Korea and Japan to the EU and the U.S.

Furthermore, the One-Belt-One-Road strategy (一带一路), seeks to ensure foreign markets for Chinese goods and ensure a trade surplus with the rest of the world. Because of massive overcapacity, external markets are essential for the survival of many over indebted Chinese industrial giants.

In reality, China is unlikely to agree to all U.S. demands, but even compliance would not solve the underlying cause of the U.S.-China imbalances. China cannot under any circumstances meet U.S. demands for greater trade equity, except through buying more American products, some of which are explicitly to be used to undermine U.S. technological dominance, though they will boost profits of several U.S. companies in the short term. Even if the Chinese government were to support the purchase of greater numbers of U.S. goods, the structure of the Chinese economy ensures its surplus with the U.S. could only decrease slightly, without significant increases in Chinese household income relative to the size of Chinese GDP.

A serious question remains over the next few years: How will the U.S. respond to continuous Chinese trade surpluses? Despite Mnuchin’s claim the trade war is “on hold” and Trump's stated desire to prevent massive Chinese job losses, questions remain as to how long this detente will last.

This brings us back to ZTE and the future of Chinese tech.

One advantage of the outsized share of national income in the hands of the government and state-aligned corporate sector is the Chinese government can channel massive resources toward strategically important sectors, keeping them afloat and and even propelling them onto the world stage. On the other hand, because of relatively weak internal demand, companies tend to rely on government backing and on foreign demand.

Because access to resources is driven not by the market but by political strategy, this form of protectionism may encourage firms to spend relatively more effort courting government concessions than innovating. If trade war begins, the Chinese government may have to decide between increasing the share of national income that reaches Chinese households and channeling resources into national champions.
Though rarely discussed, Chinese structural imbalances may prevent the Chinese government from providing the Trump administration what it desires, even if Beijing desires. Yet, there is little indication the Chinese government has any interest in accommodating the U.S., as both the Belt-and-Road and Made in China 2025 point in exactly the opposite direction.

How the U.S. responds over time and how vulnerable Chinese firms prove to trade and investment pressures must prove significant for the future of Chinese tech and innovation. If faced trade conflict abroad, Xi Jinping and the Chinese leadership will have to strike a balance between supporting national tech champions, fostering an innovative environment and increasing domestic consumption to rise. As to how this all plays out, your guess is as good as mine.

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