U.S - China Trade and Technology De-Coupling

A Brief on Tariffs, IPO’s and Frauds

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Preamble

The Trump administration has engaged in an intense competition with China on trade and technology. Until Donald Trump was elected, the U.S had a massive trade deficit with China, while Chinese tech giants were capturing the major markets in the smartphone and 5G segment. With “Make America Great Again” as his election’s core agenda and later, “America First” as his administration’s core principle of the foreign policy sees China as a strategic rival.

The U.S. in 2018 took unprecedented steps against China’s state-led mercantilist trade regime leading to President Trump authorising Section 301 of the Trade Act of 1974 as recommended by the U.S. Trade Representative. The U.S. administration, in response to these conclusions of the investigation, imposed duties worth 250 Billion USD on Chinese imports and initiated a dispute settlement at the World Trade Organisation (WTO). It challenged China’s technology licensing discriminatory regulations and enforced the Foreign Investment Risk Review Modernisation Act (FIRRMA) of 2018, which would protect the America’s critical technology and intellectual property from harmful acquisitions.
The de-coupling is not just for trade. Since 2017, the Trump Administration has targeted Chinese tech giants like ZTE and Huawei, who allegedly have links with the Chinese state and the military. This issue brief will explore various actions taken by the U.S. Government to curb Chinese technological advancements while trying to cover the gap of a massive trade deficit. The issue brief is divided into two parts, recounting the steps taken by the Trump administration on trade and technology especially against China.

**Introduction**

In March 2018, after a thorough investigation, the U.S. Trade Representative (USTR) came out with a detailed report which highlighted the four categories and policies that were analysed under Section 301 investigation;

- **China, according to the investigations, has been accused by of using foreign ownership restrictions, which included joint venture requirements, equity limitations, and other restrictions which forced U.S firms to transfer technologies to Chinese entities. Forced transfer of technology also happened through the Chinese using administrative review and licensing, which led to the undermining of U.S. investments.**

- **China imposes restriction and intervenes in investment and activities of the U.S. companies leading to Chinese depriving technology owners, especially from the U.S. to bargain and set market-based terms for technology transfer.**

- **China also directs and facilitates systematic investment. Acquisition of U.S. companies, which helps in obtaining cutting-edge technologies and intellectual properties deemed necessary in the Chinese industrial plans.**
- Unauthorised intrusion into and theft from the computer networks in the U.S. conducted by China has led to them gaining information and unauthorised access to intellectual properties, trade secrets, sensitive business information, all of which supports China’s strategic development goals which would further enhance its military modernisation and science and technology development.

The U.S., in light of this investigation, has been pursuing a dispute settlement in the WTO since March 2018, which addresses particular discriminatory technology licensing measures maintained by China. President Trump directed the USTR, based on the findings, to impose an additional tariff of 25 per cent on approximately 50 Billion USD worth of Chinese imports, which contain industrial technologies related to the Made in China 2025 plan.

In July 2018, additional tariffs worth 34 billion USD were imposed, and a further 16 Billion USD in August 2018. Following Chinese retaliatory tariffs on U.S goods, the USTR thrust on tariffs set at 10 per cent on 200 Billion USD worth of Chinese imports, which came into effect in September 2018, and in January 2019, the rate went up to 25 per cent. During the G20 Summit in Buenos Aires, Argentina, in December 2018, President Xi and President Trump met on the sidelines wherein the U.S. decided not to raise the tariffs on 200 Billion USD Chinese imports from 10 to 25 per cent.

The President of the United States also instructed the Secretary of Treasury to look into the concerns regarding Chinese investment, especially in critical industries and technology, necessary for the United States. In August 2018, Foreign Investment Risk Review Modernization Act (FIRRMA) came into effect, which modernised the tools for protecting critical technologies in the U.S. from harmful and hostile takeovers. FIRRMA also enhanced the Committee on Foreign Investment in the United States (CFIUS).
CFIUS functions include reviewing foreign investments in the U.S. for national security purposes; additional responsibilities include establishing processes for identifying foundational and emerging technologies that would be added to the existing U.S. export controls.  

> “We were relatively slow to foresee [the U.S. actions] … and underestimated [the Trump administration's] determination. Also, policy support was not well prepared,”

- Qu Fengjie, Director of the External Economy Research Institute under the National Development and Reform Commission

> “It is not simply economic friction, but a turning point of bilateral ties and a strategic adjustment of the U.S.,”

- Li Wei, Associate Professor of International Relations at the Renmin University of China.

**U.S.-China trade 2018-2019**

Li Kuiwen, the spokesperson of the General Administration of Customs (G.A.C.) and Director General of the Department of Statistics and Analysis in January 2019, while giving a yearly review of the trade, said that trade volumes had increased by 9.7 per cent year on year (YoY) reaching 30.51 Trillion Yuan in 2018. He also announced that in the foreseeable future, China is expected to maintain the top position in regards to the trade of goods. Chinese exports have increased to 7.1 per cent YoY to amounting to 16.42 Trillion Yuan while imports have increased to 12.9 per cent YoY to 14.09 Trillion Yuan. The General trade volume reached 17.46 trillion, which was up by 12.5 per cent YoY. China’s exports to the E.U. grew by 7.9 per cent.

Similarly, exports increased to the U.S. and ASEAN by 5.7 per cent and 11.2 per cent respectively, while imports from the blocs above and the U.S accounted for 41.2 per cent of China’s total imports.
China’s trade volumes with some of its Belt and Road Initiative (BRI) partners have also increased; with Russia, Saudi Arabia, and Greece, it has increased to 24 per cent, 23.2 per cent and 33 per cent respectively. The private sector in China contributed to more than half of the growth of national imports and exports. In 2018 China also reduced import tariffs on automobile parts and components and also on daily consumer goods. However, the biggest takeaway from this yearly review was that trade surplus had shrunk by 18.3 per cent, which stood at 2.33 Trillion Yuan. ² China, in November 2018, also reduced the Most Favoured Nation (M.F.N.) tariffs on 1585 taxable items. Provisional tariffs were also removed from 39 import times. In total, the reduction of the tariff applied to 19 per cent of the total taxable items with an average tariff rate falling from 10 per cent to 7.8 per cent. ³

### Most WTO Cases Against China

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<th>WHY</th>
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<td>China wants to be an exporting country.</td>
<td>The Chinese government incentivizes companies to export products through discounts, tax breaks, and cheap bank loans that are illegal under global trade rules.</td>
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<td>China wants to prioritize domestic manufacturing.</td>
<td>In one case, foreign automakers (like Volkswagen) operating in China had to buy a certain amount of their components from local Chinese suppliers or pay more than double the standard import tax on their auto parts.</td>
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<td>China favors exporting finished products, not intermediate goods that other countries can use to assemble products.</td>
<td>Through taxes and quotas, it has limited other countries’ access to Chinese minerals and other raw materials, giving Chinese companies an advantage.</td>
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U.S. trade deficit by the end of 2018 had grown to record numbers, the highest since 2006. Chinese exports to the U.S rose 11.3 per cent YoY, while imports from the U.S to China rose 0.7 per cent
in the same time. The growing trade deficit data might be flawed as China uses different calculating methods, which sometimes excludes goods that end up in the U.S. via other countries. While China seems to be growing steadily and will continue to do so, Li Kuiwen seemed wary of external factors, with the most significant worry being global economic uncertainties and protectionism. 4

“With global growth set to cool further this year, exports will remain weak even if China can clinch a trade deal that rows back Trump’s tariffs,…..Meanwhile, with policy easing unlikely to put a floor beneath domestic economic activity until the second half of this year, import growth is likely to remain subdued,”

-Julian Evans-Pritchard, senior China economist at Capital Economics

Chinese exports were the largest in the last seven years; however, it was boosted by substantial gains and the effects of order “front-loading” in the second half of 2018. The record trade deficit between U.S. and China was supported by “front-loading” by Chinese producers of products who were working against the clock to beat the January 1, 2019 deadline of tariffs being raised by 25 per cent. Total imports stood at 164.19 Billion USD, which was 7.6 per cent down compared to 2017 and went against expectations of a 4.5 per cent rise. The drop in imports is the biggest since 2016, which was a bad sign for the Chinese economy as it indicated a weakening of Chinese domestic demand, which will continue until the first half of 2019. The slowdown in export growth and the impact of “front-loading” wearing off meant that China would see a weak growth rate, and the unemployment rate continued to rise rapidly. The trade conflict’s effect can also be seen in the valuation of RMB, which is already weaker than what was projected and might come under more downward pressure, which might compel the Chinese to settle the dispute with the U.S. 5
While one could argue that years of trade deficit and President Trump’s call to “Make America Great Again” was the reason for this dispute, but it is the ‘Made in China 2025’ which has led the U.S. administration to take punitive actions against the Chinese. This is not to say that the U.S. has a problem with new industrial policies, like Germany, who also came up with their version of an “Industry 4.0” plan. However, the Chinese plans, which would involve propping up industries under Made in China 2025 through state funding, tax breaks, low-interest rates, and other subsidies, would not be transparent and made available for the business community and trading partners to know.  

The First Phase of U.S-China Trade Deal in 2020

In mid-January 2020, China and the U.S. signed the first phase of an extensive trade deal. The deal made the Chinese pledge to buy more of U.S. farm, energy, and manufactured goods in exchange for U.S. reducing tariffs. The arrangement also included eliminating Chinese pressure on technology transfer as pressure to give foreign firms market access, administrative approvals, or licensing while removing possibilities of the Chinese government taking advantage of these transfers. It also restrains the Chinese government from investing in foreign technology, which supports their industrial plans. On currency, China has promised under the purview of the deal to refrain from currency devaluation and other intimidating practices like targeting its exchange rates for a trade advantage. Any violations of currency norms would lead to punitive U.S. tariffs. For accountability, the currency agreement is based on the provisions in the US-Mexico-Canada Agreement, which requires disclosing monthly data on intervention in foreign markets and international reserve balances and public reporting to the International Monetary Fund, including a quarterly balance of payments data.
The deal was finalised around the same time when China had enforced lockdown in Wuhan after the coronavirus outbreak, which later became a pandemic. COVID-19 has been responsible for thousands of deaths around the world and, at the same time, severely impacted the global supply chains. The progress of the first phase of the trade deal has been slow but steady as China in the first half of the year was slow on meeting its commitments to buy goods at pre-2017 levels ranging from agriculture products to manufacturing goods. To monitor the progress of the deal, the meeting held in the last week of August 2020 saw the respective trade representatives discussing China’s commitment to protecting American intellectual property, a free business environment for U.S. multinational companies, and the progress of China buying goods as promised.  

Soon after this meeting, the WTO said that the U.S. tariffs are “inconsistent” with the international trade rules and regulations. China, of course, has supported this statement while the Trump administration may not take this kindly as they have been consistently critical of WTO’s role in preventing Beijing’s unfair trade practices. Even if the U.S. decides to challenge it in the WTO, the case might not move forward soon as Washington has also blocked a new appointment of judges for the appellate body. China could also move to adjudicate the case, which would take years.

The basis of WTO’s ruling on the trade war is based on the U.S. going against its commitments it signed on for in 1994. Even the European Union and Australia have supported WTO’s stance on the matter. Washington’s traditional allies hold the opinion that while they support the U.S. claims on China stealing its intellectual property but do not favour its arguments on multilateral trade. European lawyers on this matter believe that a country waving its WTO obligations to take unilateral action if another is using unfair
trade practices is “unfair and illicit under the WTO Agreement.”

US-China phase one tracker: China’s purchases of US goods

US exports and China’s imports in 2020 of all goods covered by the phase one deal as of July 2020

a. US exports and China’s imports of all covered goods in 2020, as of July, billions USD

b. China’s imports by product type, billions USD

Note: Numbers may not sum to total due to rounding. “Uncovered” products refer to China’s imports from the United States not addressed by Annex 6.1. Prorating the 2020 year-end target to a monthly basis is for illustrative purposes only. Nothing in the text of the agreement indicates China must meet anything other than the year-end target.


U.S-China Tech De-coupling

The Chinese response to the pandemic and the worsening relations with the U.S Government is aiming for what they call “dual circulation.” The term, although vague, is the way ahead after significant policy measures for the future wherein there will be two circles of economic activity—internal and external with more focus on business domestically. The new plans indicate that China recognises the new reality wherein it cannot be dependent on trade as it was for the last two decades.

The economic integration with the U.S. economy worked well for China, but the Trump administration’s pushback and “de-coupling” initiatives have left two options for Chinese companies, especially its privately-owned tech companies. TikTok and WeChat’s ban by executive order in August first week saw two different reactions. While TikTok is actively looking for a U.S. buyer to keep its business afloat, WeChat does not seem interested to do the same. The messaging app’s parent company, Tencent Holdings Ltd., which is allegedly close to the Communist Party in China, tried to make a distinction between the product and the services provided in China and abroad but did not address U.S. security allegations.

It is interesting to see the reaction and future business policies of private companies in both countries. While Tencent is not afraid to operate in China and have the full support of the Chinese government, companies like Microsoft have to tip-toe to avoid the hearings by the U.S. Congress as soon as they get into content moderation. The tech giant has already seen its American counterparts like Apple, Facebook, Google, and Amazon-branded as “cyber barons” by some members of the U.S. Congress. Bill Gates, the founder of Microsoft, has gone a step further and called TikTok a “poisoned chalice.”
Even after the scepticism surrounding the takeover of TikTok in the U.S., Oracle has decided to go ahead with it. The issue with the deal is that this is not a takeover, instead, a “partnership” between the U.S. corporate technology company and Bytedance, the parent company. The protection of data that the U.S. has been arguing is not helping as Beijing strictly refused to let Oracle examine the source code, making the Trump administration’s efforts against China look less credible.  

China’s National Pride and Technology

The escalating tensions between the U.S and China on global issues have gradually seen the technology conflict and, later, de-coupling as a priority. For more than two years, the Trump administration has been relentless in limiting Huawei’s access to the U.S. market. The onslaught started when the U.S government banned any institution, including the military, to use Huawei equipment in 2018. Later in May 2019, the White House decided to take away Huawei’s U.S. based suppliers. Furthermore, the U.S. Department of Commerce put Huawei on an ‘Entity List’ which barred it from dealing with any U.S. company. The plan was to cripple the Chinese tech giant, which has been long accused of having close ties to the People’s Liberation Army (PLA). One way was banning many of Huawei’s research affiliates and critical research facilities.

Chinese tech companies seem to have learned their lesson from the Trump administration’s actions against ZTE and Huawei. Instead of cowering down, they started looking for alternatives in Asia, especially in China. The search and later the opportunity to smaller companies, especially in China, fuel Xi’s brand of Chinese nationalism as this tech rivalry has become a cause of “national pride.” The Chinese Vice Premier Liu He is identifying companies that are vulnerable due to U.S. sanctions. These companies will get
government funding for research and development. The beginning of the year also saw the National People’s Congress (NPC) pushing provinces, cities, and companies to invest USD 1.4 Trillion over the next five years on Artificial Intelligence, 5G, industrial internet, and other new technologies. In 2019, the drive to set up a robust semiconductor industry, the Chinese government provides tax benefits, R&D support and has set up a fund worth USD 29 Billion USD.  

Both countries at the time are on a war-footing. China is pulling no punches to set up a sustainable semiconductor industry while investing and funding new technologies. Two Chinese Government-backed projects have hired more than 100 engineers from Taiwan Semiconductor Manufacturing Co. (TSMC), which until recently, was Huawei’s biggest supplier. China allegedly has also sponsored cyber-attacks on various Taiwanese chip firms called “Operation Skeleton Key.” The name of the operation is derived from the skeleton key injector technique to steal intellectual property like chip designs, Software development kits. The hacker group known as Chimera is behind these attacks and is reportedly associated with a Chinese state-backed hacker group known as Winnit.

China’s growth story, especially in the tech sector, even under the circumstances, is astonishing. By June 2020, China had added 24 more billionaires. These individuals consist of former accountants and teachers, along with software developers. A lucrative channel in China to increase fortunes is to sell shares to the public. The pandemic, although shut down large parts of the country and slowed growth, but the excitement for listing on the stock-market was well alive and has grown compared to other major markets. The euphoria related to it saw the Shanghai stock exchange beating New York and Hong Kong to be the world’s top-ranked listing venue. Behind this growth story and huge returns worth USD 70 Billion as of mid-July, have observers worried that the market is in a bubble.
Increasing Valuations through Fraud

The promising growth of Chinese tech companies and the concerns regarding their valuation is not misguided. In 2017, a company called Luckin Coffee Inc. promised to sell more coffee than Starbucks Corp. in a nation of pre-dominantly tea-drinkers by offering low priced coffee for takeout and delivery. Even though through its description, it seems like a Food & Beverage start-up, yet the founders instead called it a tech company as it had an app and called itself a disruptive force. Venture Capitalists (VC) did not at the time took much interest, but within a year, more prominent V.C. firms from China and Singapore put money worth USD 1 Billion behind the start-up.  

Luckin was doing well as it opened 5000 stores in major cities of China and reported sales worth USD 200 Million a quarter in 2019. In May 2019, the company was listed on the Nasdaq stock exchange with the support of international investors like Black Rock Inc. and banks like Credit Suisse Group AG. By July 2019, the company was valued at USD 4 Billion, which astonished Managing Partners of big V.C. firms with one even questioning, “So how can they achieve astonishing performance within a short period?”

In February 2020, Muddy Waters Research, a diligence based investment firm, tweeted an anonymous report which suggested that Luckin is committing fraud. The company’s immediate response was of denial, going as far as calling it “misleading, flawed, and meritless.” Irrespective of the denial of allegations, the company shrank by 19 per cent. Two months after the denial, the company accepted that their Chief Operating Officer, a director of the company, and other employees were found to be involved “…in misconduct, including fabricating certain transactions.” A preliminary investigation pointed out that from the second to the fourth quarter of 2019; phony sales worth USD 310 Million were reported to the investors.
Blocking the Chinese IPO’s in American Stock Markets

Soon after this fraud was caught, Nasdaq, without explicitly citing Luckin, decided to come out with new regulations. The move came in response to a lack of accounting transparency of Chinese companies hopeful of an IPO. The new regulations of Nasdaq include some countries like China whose companies need to raise USD 25 Million on their IPO. This is the first time the stock exchange has put a minimum value on the IPO’s. Meanwhile, the U.S. Securities and Exchange Commission (SEC) has been locked in a battle with Chinese companies since 2011 due to accounting irregularities.

The plans for a financial “de-coupling” had already started when the Holding Foreign Companies Accountable Act was introduced in early 2019. The act was passed by unanimous consent in the U.S. Senate in May 2020. It is yet to go through the House of Representatives and, finally, to be signed by the President of the United States of America to become a law. The act bars any company from being listed in any U.S. Securities Exchange if they do not comply with the Public Company Accounting Oversight Board (PCAOB), the accounting oversight arm of the S.E.C. The act also would ask companies to disclose whether a foreign government owns them. Senator John Kennedy from the Republican Party and Senator Chris Van Hollen of the Democratic Party were co-sponsors of this act, which shows the unanimity in the Senate on issues regarding China and its transgressions.

The first rumours of this act being finalised had led to Chinese tech stocks falling. A move like this is a clear indication that the U.S is escalating the already tense tech, trade and finance conflict with China. With this move, Chinese companies who looked forward to investment and raising money in U.S. dollars would have to
look for alternatives. The alternatives, of course, if the Shanghai stock exchange modelled on the same lines as Nasdaq, which, as mentioned before, has been responsible for multiple IPO’s even during the pandemic.  

**Future of Chinese IPO’s in Other Markets**

Since 2018 more than 60 Chinese companies have been listed on the Nasdaq and New York Stock Exchange (NYSE). The China Security Regulatory Commission (CSRC) is still investigating the Luckin fraud, but it does raise a pertinent question as to what compels Chinese companies to engage in fraudulent methods. The way forward with the new U.S. regulations will be challenging because of the scandals. It will severely affect the future of the cross-border capital market between the U.S. and China. The scandals of cross-border capital market relationships are not new. Back in 2011 and 2012, over 100 Chinese firms were suspended or delisted from various U.S. stock exchanges leading to calls for more cooperation between the governing bodies. Going forward, 2014 and 2018 saw the highest number of Chinese companies being listed on U.S. stock exchanges. The new regulations now put a big question mark on the future of big Chinese tech companies getting listed.

The alternative for Chinese tech companies with major regulatory scrutiny in the U.S. is the Shanghai-based STAR market, which is modelled on Nasdaq. The new U.S. regulations and the increasing antagonistic rhetoric might create an inhospitable environment for Chinese tech firms, which would make them, look towards Shanghai or Hong Kong. Companies like Xiaomi and Tencent have thrived in Hong Kong while, as mentioned before, the Shanghai stock exchange has put on a better performance than its counterparts in New York and Hong Kong in 2020.
**Conclusion**

The world community is beginning to realise that the Doha Round of Negotiations and discussions associated with it have failed, and WTO will continue to languish. There is a focus on “plurilateralism” as far as trade agreements are concerned through the U.S./Mexico/Canada Agreement (USMCA) or the Regional Comprehensive Economic Partnership. The U.S. does not see WTO doing much about China flouting market principles. Instead, it has chosen an alternative route where it actively engages, and somewhat under Trump, antagonises its trade partners. China, meanwhile, floods its products worldwide and blocks other countries to enter its market.

Plurilateralism is increasingly becoming relevant to the tech conflict. The U.K has proposed a Democratic Alliance consisting of 10 countries (colloquially known as D-10), including India, to discuss 5G. India, too, is hopeful that other countries would follow its lead in banning major Chinese apps like TikTok, WeChat, and PUBG, which had a significant impact on Chinese tech giants who own these apps as valuations tumbled.

The trade and technology cold war in the future, from a geopolitical point of view, would prompt western companies, especially the ones based out of the U.S., to justify their investments, which might help in the economic growth of an adversary. Furthermore, companies around the world should consult think-tanks and consider their view as geopolitical risks have increased manifold, and market forces only cannot be the driving force behind investments.

Over the last five years, the U.S.—China bilateral relations have deteriorated in. The U.S. foreign policy, especially under Trump, has taken a turn to derive mutual benefit bilateral/trilateral trade agreements guide by the rule of law established and evolving since the Bretton Woods institutions were setup. National pride,
profits, robust military firepower is all dependent on technological advancement and for investing in next-generation technology.

If the U.S. wants to succeed, it needs unwavering bipartisan support, and if China wants to beat the U.S., it needs to rework its top-down approach, which has led to a waste of resources more times than the Chinese government would admit. The way forward for China at the time is following Xi Jinping’s call to the entrepreneurs to be “patriotic and innovative.” With the doors gradually shutting on Chinese tech giants in the U.S., Europe, Japan, Australia, and now India have isolated their R&D. Even the BRICS Innovation base, which China’s Industry Minister floated in August, 2020 would face roadblocks as China has been accused by Russia of stealing military secrets. It is this predatory behaviour by stealing intellectual property, which would make trusting the Chinese state and its companies challenging to trust and cooperate with in the future.

References


25. Ibid.
About the VIVEKANANDA INTERNATIONAL FOUNDATION

The Vivekananda International Foundation is an independent non-partisan institution that conducts research and analysis on domestic and international issues, and offers a platform for dialogue and conflict resolution. Some of India’s leading practitioners from the fields of security, military, diplomacy, government, academia and media have come together to generate ideas and stimulate action on national security issues.

The defining feature of VIF lies in its provision of core institutional support which enables the organisation to be flexible in its approach and proactive in changing circumstances, with a long-term focus on India’s strategic, developmental and civilisational interests. The VIF aims to channelise fresh insights and decades of experience harnessed from its faculty into fostering actionable ideas for the nation’s stakeholders.

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